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FINANCIAL SERVICES INDUSTRY—OVERSIGHT

HEARINGS
BEFORE THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
NINETY-EIGHTH CONGRESS
FIRST SESSION
ON
PROBLEMS, OPTIONS, AND ISSUES CURRENTLY FACING THE FINANCIAL SERVICES INDUSTRY AND THE AGENCIES THAT REGULATE AND SUPERVISE THESE ENTITIES

PART II

MAY 20, JUNE 7, 8, 9, 16, 21, 27, AND 29, 1983

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S241-81

CONTENTS

PART II

FRIDAY, MAY 20, 1983

Page

Opening statement of Chairman Garn 1

WITNESSES

- Sidney A. Bailey, Commissioner of Financial Institutions for the Commonwealth of Virginia; President of the Conference of State Bank Supervisors 2
  - Nonbank loophole 2
  - Time for removal of burdensome regulatory controls 4
  - Need for more balance in regulatory structure 4
  - Prepared statement 6
    - Non-bank banks 7
    - The Fed, the States and the BHC Act 9
    - EFT legislation 11
    - Restructuring and deregulation 12
    - Regulatory parity 13
    - New bank powers 14
    - State authority over structure 15
    - Summary and conclusion 17
    - Comments to the Vice President's Task Group on Regulation of Financial Services 18
    - Comments to Office of the Comptroller of the Currency on subject applications 30
    - Policy study entitled "The Dynamic American Banking System—An Analysis of Geographic Structural Constraints" 45
- Hunter O. Wagner, Commissioner of Financial Institutions for the State of Louisiana; Vice President of the National Association of State Savings and Loan Supervisors 95
  - Thrift institutions now able to compete in financial markets 95
  - Congressional oversight on recent enacted legislation 96
  - Interstate combination of distressed institutions 97
  - Federal agency reform and consolidation 98
  - Amendments to maintain a competitive equilibrium 99
  - Prepared statement 100
    - Condition of the domestic financial services industry 101
    - Structure of the domestic financial services industry 102
    - Conclusion 111
- Jack Carlson, chief of financial services regulation of the department of corporations for the State of California; president of the National Association of State Credit Union Supervisors 111
  - Opposition to merger 112
  - Prepared statement 114
    - Introduction 114
    - Decisionmaking process 115
    - Working relationship between State and Federal regulators 116
    - Advocacy role 117
    - Summary 118
    - Memorandum of understanding between NASCUS and NCUA 119

Page
- Bruce W. Foudree, commissioner of insurance for the State of Iowa; chairman of the Financial Services Task Force of the National Association of Insurance Commissioners 121
  - Three fundamental regulatory objectives 121
  - Safeguards of bank insurance policyholders 123
  - Prepared statement 125
    - Insurance regulation today 125
    - Concerns about the integration of financial services 126
    - Conclusions 129
    - Resolution 131
- Panel discussion:
  - States better able to assess needs of its citizens 132
  - Debtor coercion 133
  - Loophole in Glass-Steagall 134
  - Financial services industry revolution 135
  - Interstate reciprocity 137
  - Limitations of smaller banks to compete 139
  - Extent of State credit union lending powers 141

TUESDAY, JUNE 7, 1983

- Opening statement of Chairman Garn 143

WITNESSES

- Frank Patterson, chairman of the Federal Affairs Committee of the Independent Insurance Agents of America; accompanied by Tom Wilson, counsel 144
  - Prepared statement 145
- Gerald K. Cassidy, past president of the National Association of Casualty and Surety Agents 153
  - Prepared statement 156
    - Introduction 157
    - Expansion of insurance activities of bank holding companies in 1970's 157
    - Enactment of title VI 158
    - Recent developments could undermine congressional action 160
    - Proposals 164
      - Moratorium 164
      - Committee statement of legislative intent 167
      - Technical amendments to close loopholes 167
    - Conclusion 168
    - Appendix A.—Letter to Paul A. Volcker 169
    - Appendix B.—Amendment to Bank Holding Company Act of 1956 172
- Edward H. Akin, president, National Association of Professional Insurance Agents 175
  - Prepared statement 175
    - Attachment A.—Letter from Paul A. Volcker to David H. Elliott, insurance commissioner, State of Delaware 188
    - Attachment B.—Moratorium proposal 190
    - Attachment C.—Letter to Paul A. Volcker 193
    - Attachment D.—Proposed amendment 195
- Richard Nielsen, on behalf of the National Association of Insurance Brokers 196
  - Prepared statement 196
- Thomas M. Gregg, National Association of Life Underwriters Committee on Federal Law and Legislation 199
  - Prepared statement 199
- Panel discussion:
  - Nonbanking institutions getting into the banking business 214
  - Fear of unfair competition 215
  - Importance of McCarran-Ferguson 217
  - Propose a one-step amendment 218
  - Authority to acquire thrifts for 50 years 220
  - Additional comments on savings and loan associations having the authority to act as agents in the sale of property and casualty insurance 222
  - Intimidation of the average man on the street 235
- Richard S. Schweiker, president, American Council of Life Insurance 236
  - Economic considerations 237
  - Concerns about the integration of banking and insurance 238
  - Beginning of a race by States 239

Richard S. Schweiker, president, American Council of Life Insurance—Con. Page
Prepared statement 241
Broad considerations 244
Economic considerations 244
Glass-Steagall considerations 252
Banking and insurance 256
State enabling legislation 256
Other specific considerations 258
Remedial legislation 265
Statement of Horace R. Baker, Jr., senior vice president and secretary, John Hancock Mutual Life Insurance Co 269
Amendment to Bank Holding Company Act of 1956 280
William W. Suttle, senior vice president for Federal affairs, American Insurance Association 281
Impact of the South Dakota law 281
Regulatory problems and conflicts 283
Recommending temporary moratorium 284
Prepared statement 285
State legislation 289
Regulatory issues 292
Credit leverage—Economic concentration 294
Treasury proposal 298
Nonbank banks 299
Conclusion 301
John Nangle, assistant vice president of the National Association of Independent Insurers 303
Prepared statement 304
Panel discussion:
Impact of moratorium 312
Insurers facing sex discrimination issue 314

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Alliance of American Insurers, views on integration of financial services 318
National Association of Independent Insurers, additional comments supplied for the record by John Nangle, assistant vice president 343

WEDNESDAY, JUNE 8, 1983

Opening comment by Chairman Garn 349

WITNESSES

John S. R. Shad, Chairman, Securities and Exchange Commission 349
October 1981 testimony 349
February 1982 testimony 350
Accelerating change 350
Fair competition 350
Margin regulations 351
SEC/CFTC coordination 351
Self-regulation 352
Shareholder communication 352
Full disclosure 352
Separate corporate affiliates 352
Prepared statement 354
Response to Senator D'Amato's question of section 23(a) of the Federal Reserve Act which regulates transactions between bank holding companies and affiliates 384
Panel discussion:
Violation of Glass-Steagall 377
South Dakota preempted Federal laws 378
Bank underwriting of corporate debt and equity 379
Direct bank brokerage services 380
Difficulties in communicating with shareholders 381
Erosion of Glass-Steagall 402
William F. Baxter, Assistant Attorney General, Antitrust Division, Department of Justice 403

- William F. Baxter, Assistant Attorney General, Antitrust Division, Department of Justice—Continued — Page
  - Major areas of reform 404
  - Creative options for interstate banking activities 404
  - Limit of freedom to diversify 406
  - Prepared statement 408
    - Geographic restrictions on bank expansion 411
    - Restrictions on product expansion by financial institutions 416
    - Modification of the merger review process 422

Panel discussion:

  - Time has come for repeal 429
  - Inadequacy of antitrust laws 430
  - Insurance of $100,000 per account is quite high 433
  - Limit FDIC insurance to small deposits 434
- George Douglas, Commissioner, Federal Trade Commission 435
  - Prepared statement 437

Panel discussion:

  - Consolidations of depository institutions regulatory agencies 442
  - Technical violations of Truth-in-Lending Act 443
  - Interstate mergers in small banker favor 445

THURSDAY, JUNE 9, 1983

Opening remarks by Chairman Garn 447

WITNESSES

- Robert B. Evans, president, American Financial Services Association; accompanied by Dr. Thomas Durkin, director of research, American Financial Services Association, Washington, D.C 447
  - Benefits of competition 448
  - What is a finance company? 448
  - The "nonbank bank" 449
  - Arguments favoring controls over nonbank banks 450
  - Prepared statement 452
    - Competition is the key 452
    - Changing consumer financial services market 453
    - A look at the finance industry 453
    - Broad diversity of financial services 455
    - Finance industry's role in consumer banking 455
    - Conclusion 460
- John F. Lee, executive vice president, New York Clearing House Association, New York, N.Y 461
  - Public demanding an array of financial services 462
  - Prepared statement 464
    - The strengthened competition 466
    - Proposals 472
    - Bank products and services 473
    - Interstate banking 476
    - Conclusion 479
    - "Freedom to Compete," testimony of May 6, 1981, submitted for the record 481
- Paul Hefner, vice president, First Interstate Bancorp, Los Angeles, Calif.; chairman of the board, Electronic Funds Transfer Association 488
  - EFT functions 488
  - Suggest changes to simplify the EFT 489
  - Eliminate restrictions on deployment of EFT terminals 490
  - Prepared statement 492
- Michael Nugent, special banking and telecommunications counsel, Electronic Data Systems, Inc., Washington, D.C.; on behalf of ADAPSO 515
  - Offer unspecified data processing to the public 515
  - Expansion of financial activities 516
  - Fed competition with the private sector 517
  - Prepared statement of Kenneth G. Riedlinger, group vice president and director of Electronic Data Systems Corp 519
    - "Data Processing," by depository institutions 523
    - The holding company subsidiary 528
    - The role of the Federal Reserve 536

Page
- Panel discussion:
  - Nonbank banks engaged in other enterprises 540
  - Additional competition in municipal revenue bonds 541
  - Recommendation to redefine a bank 543
  - Banking technology future changes 544
  - Interstate EFT operations growing 547
- Glenn Nishimura, legislative representative, Consumer Federation of America, Washington, D.C 550
  - Wholesale deregulation threatens consumer protection laws 550
  - Truth-in-savings legislation 551
  - Prepared statement 553
- James M. Hacking, assistant legislative counsel, American Association of Retired Persons, Washington, D.C 558
  - "Financial Supermarkets" 558
  - Small savings accounts may be neglected 560
  - Supplemental statement 561
  - Prepared statement 581
- Panel discussion:
  - Advocating legislative disclosure requirements 586
  - Complexity has developed around Truth-in-Lending 588

THURSDAY, JUNE 16, 1983

- Opening statement of Chairman Garn 591
- Opening remarks of Senator Heinz 701

WITNESSES

- Charles A. Bowsher, Comptroller General, General Accounting Office; accompanied by Art Goldbeck, Associate Director; Randy Schultz, Senior Evaluator 593
  - Impact of industry changes 593
  - Diversifying leads to greater risks 594
  - Prepared statement 597
    - Market direction should be understood 602
    - Reasons for restrictions need to be reassessed 604
    - Many regulatory structure alternatives exist 613
- Panel discussion:
  - Problems of auditing functions in financial services 620
  - Legislative changes instead of a moratorium 622
  - Different insurance protection 624
- K. Houston Matney, securities commissioner of the State of Maryland; chairman of the Financial Institutions Committee, North American Securities Association accompanied by: Marianne E. Roche 626
  - Comprehensive report surveying the investor protection provisions of the securities laws 627
  - Barriers erected by Glass-Steagall 682
  - Uneven pattern of legislation 684
  - Oversight of broker-dealer function 685
  - Prepared statement 686
    - Current Glass-Steagall restrictions on securities activities of financial institutions 687
    - Divergent policy approaches to banking and securities regulation 688
    - The role of State securities administrators 690
    - Proposals for legislation 694
  - Restrictions on transactions between affiliated financial institutions and securities firms on investment companies 697
- Panel discussion:
  - Support functional regulations of activities 696
  - Nonmember banks engage in securities activities 698
  - Competition between States to reduce regulations 700
- Robert E. Linton, chairman of the board, president and chief executive officer of Drexel, Burnham, Lambert, Inc., chairman of the board, Securities Industry Association; accompanied by: Edward I. O'Brien, president, Securities Industry Association 719
  - Humpty-Dumpty of financial services 719
  - Confusion dominates financial marketplace 720
  - Breathtaking change of established congressional policy 721

Panel discussion—Continued

Page
- Bank regulators undermining and destroying Glass-Steagall 722
- Prepared statement 725
  - Introduction 725
  - Congressional policy regarding nonbanking activities of banks and bank holding companies 731
  - Current expansion of securities activities of commercial banks 735
  - Public policy reasons requiring an unequivocal congressional reaffirmation of national policy on banking 738
  - The present need for additional congressional director 748

David Silver, president, Investment Company Institute 754
- Banks have not lost ground in the domestic marketplace 754
- Who is behind the move to repeal Glass-Steagall? 755
- Prepared statement 758
  - Financial assets of commercial banks and other types of financial institutions, 1982 778
  - Fifteen largest U.S. banks and their consolidated assets year end 1982 779
  - Total assets of 15 largest bank trusts 780
  - Position of the Investment Company Institute with respect to 1983 congressional hearings on the Glass-Steagall Act and related laws 781

Donald H. Treadwell, president-elect, National Association of Realtors 786
- Basic functions of real estate brokers 786
- Problems of tie-in sales 787
- Future of housing credit in a deregulation environment 789
- Prepared statement 790
  - Should Congress further deregulate Federal financial institutions? 791
  - What needs to be considered with a rapidly changing private financial services marketplace? 797
  - What is the future of housing credit in a deregulated environment? 798
  - Correspondence to the FHLBB about a federal savings and loan in Lincoln, Nebraska 800

Marvin Gilman, Wilmington, Del.; chairman of the Mortgage Finance Committee, National Association of Home Builders 808
- Builder bonds 809
- Prepared statement 812
  - Status of the housing industry—outlook 813
  - Housing and credit 814
  - Primary mortgage market 816
  - Secondary mortgage market 817
  - Trusts for investments in mortgages [TIM's] 820
  - Builder bonds 821
  - Pension funds, retail and foreign investors 823
  - NAHB innovations 828
  - Reform of financial regulatory agencies 830
  - Consolidation of financial institutions 831
  - Direct investment in real estate by financial institutions 833
  - Conclusion 836

Dr. Thomas R. Harter, senior staff vice president and chief economist, Mortgage Bankers Association 839
- Shift in mortgage lending activity 839
- Credit budget limits 839
- Conflict in the area of prepayment privileges 840
- Prepared statement 842
  - Expansion of financial institutions' authority 843
  - Success of money market funds 844
  - Expanded market 846
  - Effect of deregulation 846
  - Secondary market 848
  - FNMA and FHLMC mortgage purchase limits 849
  - Rate and other regulatory restrictions 850
  - Origination competition 852
  - Localized versus national mortgage markets 854
  - Artificial limits on secondary market activities 857
  - Regulatory impediments to mortgage credit 859
  - Conclusion 860

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Page
- American Association of Retired Persons 704
- American Land Title Association 705
- Conference of State Bank Supervisors 707
- Independent Bankers Association of America 708
- Independent Insurance Agents of America 710
- Investment Company Institute 711
- National Association of Casualty & Surety Agents 712
- The National Association of Life Underwriters 713
- Professional Insurance Agents 715
- Securities Industry Association 717

TUESDAY, JUNE 21, 1983

- Opening statement of Senator Heinz 863

WITNESSES

- Doug Barnard, Jr., Member of the U.S. House of Representatives from the State of Georgia 865
  - Letters from Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System to:
    - Congressman Fauntroy 866
    - Senator Heinz 868
  - Letters of endorsement of legislation from:
    - American Bankers Association 871
    - The Consumer Bankers Association 872
    - National Association of Federal Credit Unions 874
    - National Savings and Loan League 875
    - U.S. League of Savings Institutions 876
    - National Association of Mutual Savings Banks 877
    - Prepared statement 880
- Dr. Irving Leveson, director of economic studies, Hudson Institute, Croton-On-Hudson, N.Y 885
  - Relaxing regulatory restrictions 885
  - Workability of deregulation 886
  - Prepared statement 889
    - Controlling money shouldn't stop financial deregulation 889
    - Deregulation will work 890
    - Deregulation should be broad-based 891
- George G. Kaufman, professor, Department of Finance, Loyola University of Chicago, Chicago, Ill 893
  - Implications of changes for efficiency 893
  - General antitrust laws should be examined 894
  - Prepared statement 896
- Edward J. Kane, professor, Department of Economics, Ohio State University, Columbus, Ohio 899
  - Reregulation 899
  - Risk-taking increases fragility of our financial system 900
  - Changes in contract provisions 901
  - Prepared statement 903
    - Competition among regulators 904
    - Structural arbitrage and deposit-insurance risk exposure 905
    - Insurance subsidies are shifted 908
    - Six point program for reregulation 911
- Paul M. Horvitz, professor, College of Business Administration, University of Houston, Houston, Tex 916
  - Depositors look to the FDIC or FSLIC for protection 916
  - Necessary elements for a regulatory structure 917
  - Prepared statement 919
- Panel discussion:
  - Expansion to other financial services 932
  - Risk-pooling 933
  - Request wide-scale study of separation between banking and commerce 934
  - Moratorium until a solution is found 936
  - Testing out a regulatory system 937
  - Activities banks should not engage in 938

Panel discussion—Continued | Page
Risks in investment banking 940
Community deposits for loans to Brazil 943
International depository insurance 944
Areas of agreement 945
Conducting incremental financial activities through separate subsidiaries. 947
Should banks own underwriting firms or underwriting firms own banks?.. 949
Comments on FDIC insurance study 953

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

"Changing Technology and Future Financial Activity," by Almarin Phillips, the Wharton School, the University of Pennsylvania 955

MONDAY, JUNE 27, 1983

Opening statement of Chairman Garn 987
Opening statement of Senator Proxmire 988

WITNESSES

James D. Robinson III, chairman, American Express 990
Consumers continue the demand for new products and services 991
Financial industry facing many unresolved questions 992
Temporary moratorium may not be temporary 993
"Rent-a-State" 994
Separate subsidiary approach 995
Prepared statement 998
Samuel H. Armacost, president and chief executive officer, BankAmerica Corp., San Francisco, Calif 1007
Prepared statement 1008
Finn M. W. Caspersen, chairman of the board, Beneficial Corp., Peapack, N.J. 1021
Many consumer banks owned by nonbanking entities 1021
Prepared statement 1024
Walter B. Wriston, chairman, Citicorp, New York, N.Y 1029
Prepared statement 1035
Roger E. Birk, chairman of the board, Merrill Lynch & Co., Inc., New York, N.Y 1040
Prepared statement 1041
Introduction 1041
Merrill Lynch & Co 1041
Objectives 1042
Evolution of the financial services industry—the proposed moratorium 1042
Conclusion 1046
Robert A. Beck, chief executive officer and chairman, Prudential Insurance Co. of America, Chicago, Ill 1047
Prepared statement 1048
Edward R. Telling, chairman of the board and chief executive officer, Sears Roebuck & Co., Chicago, Ill 1053
Brief statement 1054
Prepared statement 1060
Panel discussion:
Competition in California 1070
Competition in New York 1070
Opinions of functional regulation 1071
Position on moratorium 1072
Impact of acquisitions of S&L's by securities firms 1073
Repeal of the Glass-Steagall Act 1073
No need for 100 percent FDIC coverage on deposits 1074
Organize a commission to study banking problems 1076
Financial marketplace operating very good for consumer 1078
Interstate banking encouraged 1080
Proceed with caution on deregulation 1081
Nonbank banks are no danger to consumer 1083
Risk-taking 1085

WEDNESDAY, JUNE 29, 1983

Page
Opening remarks of Chairman Garn 1091

WITNESSES

James E. Smith, president, Charles E. Walker Associates, Inc., Washington, D.C 1091
  Modernization of public policy demand congressional enactments 1092
  Deficiencies of Treasury recommendations 1093
  Prepared statement 1095
Garth Marston, chairman, Providence Institution for Savings, Boston, Mass 1103
  Suggestions of lower cost of mortgage funds 1104
  Importance of mortgage pools 1105
  Oral statement 1107
  Prepared statement 1115
    Liability side deregulation 1116
    Shorter maturity portfolios 1119
    Adjustable rate mortgages 1119
    Homeowners prefer fixed-rate mortgages 1121
    Mortgage pools in the mortgage market 1121
    Thrifts and mortgage pools 1124
    The problem 1128
    The solution 1129
    Prepayment adjustment means lower mortgage rates 1136
    Special cases 1137
    Conclusion 1137
    Addendum 1139
    Table I.—Deposits in money market demand accounts at institutions.. 1117
    Table II.—Comparative rates for yields on money market funds and money market deposit accounts 1118
    Table III.—Distribution of funds at S&L institutions 1120
    Table IV.—Prepayment fee on 30-year, 12-percent mortgage, original balance, $100,000 1133
    Table V.—Prepayment bonus on 30-year, 12-percent mortgage, original balance, $100,000 1135
    Chart I.—Monthly yields on adjustable rate mortgages versus 6-month T-bills and 30-year Treasury bonds 1122
    Chart II.—Percent of mortgages with adjustable rates 1123
    Chart III.—Interest rates on adjustable rate and fixed rate mortgages 1123
    Chart IV.—Holdings of the mortgage pools 1125
    Chart V.—Share of funds provided to finance home mortgages 1126
    Chart VI.—Share of originations and net acquisitions of mortgages by S&L institutions 1127
    Chart VII.—Yields on GNMA securities 1130
Philip Coldwell, Coldwell Financial Consulting, Washington, D.C 1140
  Growing uncertainty in the financial industry 1140
  Congress faces challenge of providing guidance 1142
  Prepared statement 1144
A. A. Sommer, Jr., Morgan, Lewis & Bockius, Washington, D.C 1152
  Unevennesses in the playing field 1153
  Need of a mechanism for fair and equal treatment 1154
  New post in the administration 1155
  Prepared statement 1157
Muriel F. Siebert, chairman and president, Siebert and Co., New York, N.Y 1169
  Financial industry has outgrown its rules 1169
  Major steps to restore order 1170
  Prepared statement 1173
Panel discussion:
  Global job of deregulation 1186
  Five-percent limitation 1187
  Go slowly in repeal of Glass-Steagall 1188
  Legislative moratorium of 6 months 1189
  Alternative to a legislative moratorium 1190
  Misimpressions about nonbank banks 1193
William J. Dennis, director of research, National Federation of Independent Business; accompanied by George Saunders 1196
  Clarification of existing law is necessary 1197

William J. Dennis, director of research, National Federation of Independent Business; accompanied by George Saunders—Continued Page
  Prepared statement 1199
  NFIB study entitled, "Credit, Banks and Small Business" 1212
  Concerned about takeover of small local banks 1269

FINANCIAL SERVICES INDUSTRY—OVERSIGHT

Part II

FRIDAY, MAY 20, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn and Hecht.

OPENING STATEMENT OF CHAIRMAN GARN

The **CHAIRMAN**. The Senate Banking Committee will come to order.

Today, we continue the sixth day of hearings on oversight into competition within the domestic financial services industry.

We are happy to have before us another distinguished panel to testify: Mr. Sidney A. Bailey, commissioner of financial institutions for the Commonwealth of Virginia and president of the Conference of State Bank Supervisors; Hunter O. Wagner, commissioner of financial institutions for the State of Louisiana and vice president of the National Association of State Savings and Loan Supervisors; Jack Carlson, chief of financial services regulation of the department of corporations for the State of California and president of the National Association of State Credit Union Supervisors; and Bruce W. Foudree, commissioner of insurance for the State of Iowa, chairman of the financial services task force, National Association of Insurance Commissioners.

Gentlemen, we are happy to have you with us today. I will apologize in advance and say that I would expect that I will be the only Senator here today. We stayed in until after midnight last night on the budget, and finally had a resounding vote of 50 to 49 to pass a budget resolution. I hesitate to call it that, what we turned out, but nevertheless, as a result of that late night, there are going to be no votes on Friday. Around the Senate, when there are no votes, the attendance of Senators does not stay too high.

There aren't too many of us around today, but I am certainly pleased to have you here today, and looking forward to your testimony.

Mr. Bailey, would you like to begin, please.

STATEMENT OF SIDNEY A. BAILEY, COMMISSIONER OF FINANCIAL INSTITUTIONS FOR THE COMMONWEALTH OF VIRGINIA, PRESIDENT OF THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. **Bailey**. Thank you, Mr. Chairman. I am Sidney A. Bailey, the commissioner of financial institutions for the Commonwealth of Virginia.

The **Chairman**. Already, I have been proven wrong, less than 30 seconds later.

We're happy to have you, Senator Hecht, even though you did prove me totally wrong in that statement I just made. I said because we were not having votes on the Senate floor today that I would probably be the only Senator at the hearing, and you walked in. It's not the first time I have been wrong.

Excuse the interruption, Mr. Bailey.

Senator **Hecht**. It's the third, if I remember correctly. [Laughter.]

The **Chairman**. At least. [Laughter.]

Please go ahead.

Mr. **Bailey**. I am also president of the Conference of State Bank Supervisors, on whose behalf I am testifying today, and we are very pleased to have this opportunity to testify before this Committee and address our concerns.

NONBANK LOOPHOLE

The No. 1 short-range priority for CSBS is a congressional solution to the so-called nonbank bank loophole. The nonbank bank loophole allows entrepreneurs to acquire and operate banks without regard to the Bank Holding Company Act or controls over the mixing of banking with other lines of commerce.

Recent developments in the banking marketplace have underscored significant inroads which can be made using this legal maneuver. Under this, for example, a multibillion dollar mutual fund company has acquired a bank and an investor group, led by an oil and gas entrepreneur, is attempting to set up a holding company for 31 banks in 25 States.

We support the Fed's efforts on behalf of a legislative moratorium now, and we would like to see a solution through an amendment to section 2 of the act redefining for the purposes of the act the definition of a bank. Perhaps one long-term solution is to regulate through a depository institutions holding company act all depository institutions with statutory authority to engage in similar activities. Such an approach has been taken in Maine, where substantive differences between State-chartered institutions have been lessened over the past few years.

In the meantime, CSBS has expressed strong opposition to the pending applications by the Dimension Financial Corp. I have attached a copy of our comments on this matter to our testimony and ask they be made a part thereof.

Historically, the initiative for the regulation of bank holding companies, like most bank innovations, has originated at the State level. It was not until the Bank Holding Company Act of 1956 that extensive Federal control was instituted. Then and subsequently when the act was amended in 1966 and 1970, Congress consistently reserved the right of States to prohibit the formation of bank holding companies within their boundaries and to prohibit certain of their activities, despite the rulings from the Federal Reserve Board.

The current statutory arrangement has great merit. The role of the States with regard to bank holding company structure is to insure that the broad policy direction determined by the board in the national interest does not adversely impact on individual State economies or financial institution structures.

Congress reinforced this concept by including in the act not only the general reservation of State authority in section 7 but the Douglas amendment in section 3, as well. States have exercised the authorities reserved to them with diligence and have proven responsive to change. Delaware has allowed interstate bank holding company acquisitions by State law to meet its citizens' needs. Maine has had a nationwide reciprocal provision in its statute since 1975 and New York has recently followed suit. Massachusetts has just passed a statute allowing interstate acquisition on a regional basis. West Virginia has completed a major recodification of its holding company legislation. Several other States have acted or are now contemplating changes in their State holding company statutes.

However, the authorty of States to condition a Douglas permission on a regional basis remains in question. Congress can, of course, clarify the scope of its delegation by specifying that limitation such as to geographic region or conditions of entry were anticipated and that it was intended that the delegation of power be broad enough to encompass them. CSBS would support such a clarifying amendment.

In essence, the system devised by Congress is working well. Respective State and Federal agencies are performing exactly the roles intended for them.

It was not long ago that advocates of repeal of the Douglas amendment were telling you that repeal was necessary because states were not doing anything and would not be responsive. But states have acted in a time and manner appropriate to the needs and desires of their citizens. Now those same advocates of repeal would stand their previous argument on its head. They would leverage a succcessful State-originated New England regional approach into a federally mandated holding company structure on a nationwide or multiregional basis.

We implore you to reject this backward logic. The facts support the theses that the current holding company system does work and that states are responsible repositories for powers reserved to them in section 3 and section 7 of the Bank Holding Company Act.

Another area in which States have proved their ability to accommodate changes in the marketplace is that of electronic funds transfer systems; 38 States now have EFT legislation on their books; 17 States already explicitly provide for their banks to communicate with and/or make arrangements with banks in other states to have "other State" bank customers provided typical EFT services on their deposit accounts.

TIME FOR REMOVAL OF BURDENSOME REGULATORY CONTROLS

Now is certainly an appropriate time for removal of excessively burdensome regulatory controls, including elimination of overlapping and duplicative examination of the supervisory reviews; however, CSBS believes current market conditions dictate that now is not the time for major changes in regulatory structure.

Financial institution management teams are and will be sufficiently challenged by current business conditions without adding to their problems by creating unfamiliar regulatory structures. Regulators, too, do not need to be diverted from the essential task of maintaining institutional safety and soundness. At this time, the illusion of progress through massive reorganization could have important real costs.

Mr. Chairman, when you became chairman of this committee in the 97th Congress, you promised a comprehensive review of all recently enacted banking law and regulation by this committee. As we indicated at that time, we would be happy to participate with you in removing inefficient, wasteful, and burdensome regulatory activity mandated by statutory excesses.

I have attached a copy of my comments to the Vice President's task group on regulation of financial services on behalf of CSBS to this testimony and request they be made a part of the record.

NEED FOR MORE BALANCE IN THE REGULATORY STRUCTURE

In order to maintain and strengthen the dual system there is a need for more balance in the regulatory structure. Congress can accomplish this by mandating parity for the State bank regulators and the Comptroller of the Currency. It seems logical that the Federal Reserve and FDIC should accept State examinations and regulation to the extent that they will accept those of the Comptroller. This can be accomplished if first Congress mandates a 5-year phase-in for such acceptance, absent a showing on a State-by-State basis of why the State examination is insufficient; and second, that the FDIC broadens its acceptance of State determinations in routine branch and headquarter relocations and other applications for structural changes as it does now with such decisions by the Comptroller of the Currency.

CSBS has as a body adopted a policy which would endorse some expansion of banking powers, following the weighing of public interest considerations. A copy of that policy is included in our comments to the Vice President's task group, already made a part of this testimony.

We recognize that change is needed and that the initiative for needed changes are a responsibility of both the private and regulatory sectors. The economic viability and thus the safety and soundness of banks demands that they be allowed to compete in the marketplace.

Yet it is clearly in the public interest to maintain some fundamental distinctions between banking and other lines of commerce. Safety and soundness regulation is the cornerstone of bank supervision because of banks' unique role in the payments system, as intermediaries between organizations and people and as the safekeepers of depository funds and savings not placed at risk. Further, because banks use the public's money to serve the public's credit needs, uncontrolled mixing of banking and commerce would create a most sensitive situation, rife with potential conflicts of interest.

I would note that a key to the success of the dual banking system has been its ability to foster competitive innovation. We have seen this just recently in the thrust by a number of States for competitive rate instrument authority for their banks and thrifts and in State electronic funds transfer initiatives. The critical element has always been the creative tension between the two systems which lead to innovation.

I have already addressed at some length the responsiveness of States to changes in the marketplace and the needs and desires of their citizens. I shall not belabor the point further, but I would be remiss if I did not take this opportunity to reaffirm the conference's abiding faith in certain concepts.

As you know, this Congress and those before it have adopted a clear and consistent national policy of avoiding excessive concentrations of economic and financial resources. That principle is a cornerstone of the dual banking system. The conference would balk at any suggestion that a reappraisal of that policy is necessary. The McFadden Act and the Douglas amendment to the Bank Holding Company Act helped implement this policy by giving to the various States the major role in determining the banking structure best suited to the needs of their citizens. Decentralized control of structure provides the primary safeguard against undue concentration of financial resources and regulatory authority over those resources.

The conference recently released a policy study which studies in some depth the question of State authority over structure. I have attached copies to my testimony and ask that they be made a part of the record. I would also note that there is a 5-page executive summary contained therein.

The consistent CSBS theme recently has been that States are the vehicle, not the obstacle, in the necessary and desirable evolution of financial services and of the regulation of the institutions providing those services. We are proud of the States' record and proud of our role in upholding the dual banking system. True, there is some fine-tuning, such as closing the nonbank bank loophole, which needs to be done, and we trust that you will do it; however, any suggestion that the system Congress designed is not working is unfounded. Like the legendary timepiece, it takes a licking and keeps on ticking.

Thank you.

[The complete statement follows:]

STATEMENT OF MR. SIDNEY A. BAILEY

ON BEHALF OF

THE CONFERENCE OF STATE BANK SUPERVISORS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

U.S. SENATE

RE: ISSUES RAISED BY THE CONDITION AND STRUCTURE OF, AND COMPETITION WITHIN, THE DOMESTIC FINANCIAL SERVICES INDUSTRY

MAY 20, 1983

Mr. Chairman, members of the Committee, I am Sidney A. Bailey, Commissioner of Financial Institutions for the Commonwealth of Virginia and President of the Conference of State Bank Supervisors, on whose behalf I am testifying today.

The Conference of State Bank Supervisors (CSBS) is the professional organization of state officials who charter, regulate and supervise the approximately 10,500 state-chartered commercial and savings banks of the nation. Created in the early 20th Century as a clearing house for the ideas of the state bank supervisors on common problems, CSBS has evolved into the major champion of our decentralized American banking and bank regulatory structures. In addition, the Conference has become the most significant single source of educational and research services aimed at strengthening individual state banking departments.

We are pleased to have this opportunity to testify before this Committee and address our concerns.

Non-Bank Banks

The number one short-range priority for CSBS is a Congressional solution to the so-called "non-bank bank" loophole. The non-bank bank loophole allows entrepreneurs to circumvent the will of Congress by acquiring and operating banks without regard for the Bank Holding Company Act or controls over the mixing of banking with other lines of commerce. Recent developments in the banking marketplace have underscored significant in-roads which can be made using this legal maneuver. Under this, for example, a multi-billion dollar mutual fund company has acquired a bank and an investor group led by an oil-and-gas entrepreneur is attempting to set up a holding company for 31 banks in 25 states ("Dimension"). The Conference of State Bank Supervisors supports the efforts of the Federal Reserve Board to close the "non-bank bank" loophole.

Section 2 of the Bank Holding Company Act defines a bank as an institution that both accepts deposits available on demand and makes commercial loans. Divestiture of either of these roles allows the "non-bank bank" to avoid key aspects of the current statutory scheme while retaining its bank charter, The Federal Reserve has recently interpreted the Act's definition of commercial loans to include a broader array of loans than included theretofore. Such a clarification is within the Fed's authority. However, the clarification is insufficient to prevent continuing attempts to circumvent the Act.

The weakness of regulatory, as opposed to statutory, solutions to the "non-bank bank" problem can be seen in the Comptroller of the Currency's moratorium. The Comptroller's action does not apply to change of control of existing institutions, nor has it been extended to applications already accepted.

We support the Fed's efforts on behalf of a legislative moratorium now and would like to see a permanent solution through an amendment to Section 2 of the Act redefining for the purposes of the Act the definition of a bank. Perhaps one long-term solution is to regulate through a "depository institutions holding company act" all depository institutions with statutory authority to engage in similar activities. Such an approach has been taken in Maine, where substantive differences between state-chartered institutions have been lessened over the past few years.

In the meantime, CSBS has expressed strong opposition to the pending Dimension applications for at least five reasons: lack of legal authority, contravention of the intent of Congress, undisclosed intentions, violation of the public interest and lack of significant redeeming merits. I have attached a copy of our comments and legal opinion on this matter to my testimony and ask that they be made a part thereof.

The Fed, The States And The BHC Act

Historically, the initiative for the regulation of bank holding companies, like most banking innovations, originated at the state level. It was not until the 1930s that instability within the banking structure caused bank holding companies to become a federal concern. By then, three states already had statutes dealing specifically with the regulation of holding companies and six states actually prohibited banks from owning shares in other banks.

While the Banking Act of 1933 contained provisions dealing with bank holding companies, it was not until the Bank Holding Company Act of 1956 (Act) that extensive federal control was instituted. Then, and subsequently when the Act was amended in 1966 and 1970, Congress consistently reserved the right of the states to prohibit the formation of bank holding companies within their boundaries and to prohibit certain of their activities despite rulings by the Federal Reserve Board that they were permissible.

The current statutory arrangement has great merit. The Federal Reserve Board is best suited among federal agencies because it has both the scope of perspective and the information at hand to be able to gauge the risk involved in mixing banking and commerce through the bank holding company. The Board is already focused on the interrelationship of the financial and commercial sectors as a result of its central bank and monetary policy functions. The health of the economy and the safety and soundness of the nation's financial system are both within the Board's ambit.

The states share many of these goals with the Board, but, in keeping with American federalism, are focused at the local level. The role of the states with regard to the bank holding company structure is to ensure that the broad policy directions determined by the Board to be in the national interests do not adversely impact on individual state economies or financial institution structure. Congress reinforced this concept by including in the Act not only the general reservation of state authority in Section 7, but the Douglas Amendment to Section 3 as well.

States have exercised the authority reserved to them with diligence and have proven responsive to market pressures for change. Delaware has allowed interstate bank holding company acquisitions conditioned by state law to meet its citizens' needs. Maine has had a nationwide reciprocal provision in its statute since 1975 and New York has recently followed suit. Massachusetts has just passed a statute allowing interstate acquisition on a regional basis. West Virginia has completed a major recodification of its holding company legislation. Several other states have acted or are now contemplating changes in their state holding company statutes. However, the authority of states to condition a Douglas permission on a regional basis remains in question. Congress can, of course, clarify the scope of its delegation by specifying that limitations such as to geographic region or conditions of entry were anticipated and that it was intended that the delegation of power be broad enough to encompass them. CSBS would support such a clarifying amendment.

In essence, the system devised by Congress is working well. Respective state and federal agencies are performing exactly the roles intended for them.

It was not long ago that advocates of repeal of the Douglas Amendment were telling you that repeal was necessary because states were not doing anything and would not be responsive. But states have acted in a time and manner appropriate to the needs and desires of their citizens. Now those same advocates of repeal would stand their previous argument on its head. They would leverage a successful state-originated New England regional approach into a federally mandated holding company structure on a nationwide or multi-regional basis.

We implore you to reject this backward logic. The facts support the theses that the current holding company system does work and that states are a responsible repository for the powers reserved to them in §3 and §7 of the Bank Holding Company Act.

EFT Legislation

Another area in which states have proven their ability to accommodate changes in the marketplace is that of electronic funds transfer. Interestingly, they have in large part successfully overcome possible structural barriers to ensure the offering of customer services on an interstate basis. Thirty-eight states today have EFT legislation on their books. Seventeen states already explicitly provide for their banks to communicate with and/or make arrangements with banks in other states to have "other state" bank customers provided typical EFT services on their deposit accounts, through locally-owned and supervised facilities, while they are away from their banks in the host state. Only three states explicitly prohibit interstate communication.

This type of legislation offers the best of both worlds. Bank customers take advantage of state-of-the-art electronic banking services; financial institutions have the opportunity to better serve their communities, while maintaining their customer bases; and advances in technology have not been used to foster undesired consolidations of financial powers and resources.

Restructuring And Deregulation

I was recently requested to submit CSBS' views on federal and state regulation of financial institutions for the Vice President's Task Group on Regulation of Financial Services. What I stated then still applies. For that reason, I have attached a copy of my comments to this testimony and request that they be made a part thereof.

Now is certainly an appropriate time for removal of excessive and burdensome regulatory controls, including elimination of overlapping and duplicative examination and supervisory reviews, especially between state and federal agencies. Some expansion of bank and bank holding company roles may be necessary to meet market challenges.

However, CSBS believes current market conditions dictate that now is not the time for major changes in regulatory structure.

Financial institution management teams are and will be sufficiently challenged by current business conditions without adding to their problems by creating unfamiliar regulatory structures. Regulators, too, do not need to be diverted from the essential task of maintaining institutional safety and soundness. At this time, the illusion of progress through massive reorganization could have important real costs.

Mr. Chairman, when you became Chairman of this Committee in the 97th Congress, you promised a comprehensive review of all recently enacted banking law and regulation by this Committee. As we indicated at that time, we would be happy to participate with you in removing inefficient, wasteful and burdensome regulatory activity mandated by statutory excesses.

Regulatory Parity

In order to maintain and strengthen the dual system there is a need for more balance in the regulatory structure. Congress can accomplish this by mandating parity for the state bank regulators and the Comptroller of the Currency. Today, the most significant feature of duplication and redundancy in bank supervision is the double track that each state-chartered institution must follow in regulation and examination, as well as in market entry and expansion. This occurs with the addition to state supervision of redundant supervision by the FDIC or the Federal Reserve, while national banks have a single track--the Comptroller. It seems logical that the Federal Reserve and FDIC should accept state examinations and regulation to the extent that they will accept those of the Comptroller. This can be accomplished if Congress mandates a five-year phase-in for such acceptance, absent a showing on a state-by-state basis of why the state examination is insufficient, and if the FDIC broadens its acceptance of state determinations in routine branch and headquarter relocations as it does now with such decisions by the Comptroller.

The concept of regulatory parity is examined in detail in the letter to Vice President Bush which, as I previously noted, has been attached to this testimony.

New Bank Powers

CSBS recognizes that some expansion of bank and bank holding company roles may be necessary to meet market challenges. We have, as a body, adopted a policy which would endorse some expansion of banking powers, following a weighing of public interest considerations. A copy of that policy is included in our comments to the Vice President's Task Group, already made a part of this testimony.

In the context of the current debate over new bank powers, we feel strongly that there must be a reaffirmation of the uniqueness of banking and its importance to the economic fabric. I am not advocating maintaining the status quo. We recognize that change is needed and that the initiatives for needed changes are a responsibility of both the private and regulatory sectors. The economic viability and thus the safety and soundness of banks demands that they be allowed to compete in the marketplace.

Yet, it is clearly in the public interest to maintain some fundamental distinctions between banking and other lines of commerce. Safety and soundness regulation is the cornerstone of bank supervision because of banks' unique role in the payments system, as intermediaries between organizations and people and as the safekeepers of depository funds and savings not placed at risk. While it is in the public interest for other lines of commerce to take aggressive entrepreneurial risks--not so with banking. The uncontrolled breakdown of the barriers between banking and commerce could so weaken the safety and soundness of banks as to constitute a massive disservice to the public interest.

Further, because banks use the public's money to serve the public's credit needs, it creates a most sensitive situation rife with potential conflicts of interest. There exists, always, the real danger that as banking and commerce intermingle and create situations in which banks either control or are controlled by nonbank interests, the interrelationships may be allowed to dictate credit decisions to the potential detriment of the general public.

I would note that a key to the success of the dual banking system has been its ability to foster competitive innovation. We have seen this just recently in the thrust by a number of states for competitive rate instrument authority for their banks and thrifts in the face of DIDC inaction. We have seen it for a decade in state electronic funds transfer initiatives. The various state systems usually have served as the laboratories of change; occasionally, the federal system has so served. The critical element has always been a creative tension between the two systems which leads to innovation.

State Authority Over Structure

I have already addressed at some length the responsiveness of states to changes in the marketplace and the needs and desires of its citizens. I shall not belabor the point. But, I would be remiss if I did not take this opportunity to reaffirm the Conference's abiding faith in certain concepts.

As you know, this Congress and those before it have adopted a clear and consistent national policy of avoiding excessive concentrations of economic and financial resources. That principle is a cornerstone of the dual banking system. While value judgments must always be made as to questions of degree in applying such broad policies, the Conference would balk at any suggestion that a reappraisal of that policy is necessary.

This policy is fundamental to the American banking system. The McFadden Act and the Douglas Amendment to the Bank Holding Company Act help implement this policy by giving to the various states the major role in determining the banking structure best suited to the needs of their citizens. The Congress, over a 200 year history, has consistently reaffirmed its belief that decentralized control of structure provides the primary safeguard against undue concentration of financial resources and regulatory authority over those resources.

The Conference recently released a policy study entitled "The Dynamic American Banking System--An Analysis of Geographic Structural Constraints". This analysis discusses in some depth the question of state authority over structure and I have attached copies to my testimony and ask that they be made a part thereof. I would also note that there is a five page executive summary contained therein for those of you who may be pressed for time.

Summary And Conclusion

My predecessor as Conference President, Michael Edwards of Washington, had a consistent theme during his term of office. It was that the states are the vehicle and not the obstacle in the necessary--the desirable--evolution of financial services and of the regulation of the institutions providing those services. Mike has proved to be quite a prophet as the States have increasingly taken initiatives to make a wider range of banking services widely available, even across state lines, and to improve the competitive position of the traditional depositories vis-a-vis the nonregulated financial intermediaries.

We are proud of the states' record and proud of our role in a dynamic dual banking system. It is true that some fine-tuning, such as closing the "non-bank bank" loophole, needs to be done and we trust that you will do it. However, any suggestion that the system Congress designed is not working is unfounded. Like the legendary timepiece, it takes a licking and keeps on ticking.

Thank you, Mr. Chairman.

CONFERENCE OF STATE BANK SUPERVISORS
CSBS

OFFICE OF THE PRESIDENT

March 14, 1983

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The Vice President
Task Group on Regulation of
Financial Services
Room 1060
Department of the Treasury
15th Street and Pennsylvania Ave., N.W.
Washington, D.C. 20220

Dear Mr. Vice President:

The Conference of State Bank Supervisors (CSBS) is the professional organization of state officials who charter, examine, regulate and supervise the approximately 10,500 state-chartered commercial and mutual savings banks of the nation. Created in the early 20th Century as a clearing house for the ideas of the state bank supervisors on common problems, CSBS has evolved into the major champion of our decentralized American banking and bank regulatory structures. In addition, the Conference has become the most significant single source of educational and research services aimed at strengthening individual state banking departments.

We are pleased to have this opportunity to present our views on the existing system of federal and state regulation of financial institutions to your Task Group on Regulation of Financial Services.

The Dual System

The primary goal of the Conference of State Bank Supervisors is to serve the public interest through the maintenance of a viable, decentralized dual banking system as an important link in our system of state/federal checks and balances. Freedom of conversion between state and federal charters provides a major safeguard against regulatory monopoly and its inherent excesses.

At the heart of the dual banking system is the longstanding American policy against undue concentration of financial

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resources. Congress, over the years, has sought to preserve authority over financial resources at the local level, maintaining a wide dispersion of control both as to ownership and as to regulation. It should be emphasized that the Conference believes that a broad range of both sizes and types of institutions is necessary to a healthy economy. Large national institutions and holding companies are vital to our economic well-being in that they have a deposit base which enables them to make the size and type of loans necessary to finance large corporations. Banks and holding companies with a regional outlook and those with a local perspective, similarly, have a specific market sector to which they are attuned and which they endeavor to serve. History has shown the dual banking system to accommodate the needs of all banking institutions, while assuring sensitivity to the financial and economic needs of both individual communities and large corporations.

Our current banking system is not only efficient, it is sensitive to our long-range national economic needs in ways which no other system can match. Benefits which flow from it include:

. Diversity of both Size and Type of Institution--This diversity insures that all geographic areas and all sectors of the economy will be adequately served.

. Diversity of Regulation--The prevention of monopoly in regulation insures against unduly burdensome regulation and against undue influence being attained by any public or private interest group.

. Competition--The maintenance of the entry level and discrete areas of competition guarantees a wider range of institutions and services among which the public can shop.

. Flexibility--The ability of institutions and regulators to take into account differences in the economies of the markets which they serve insures that local as well as worldwide needs will not be ignored.

. Responsiveness--The accessibility of bank management to their community and of regulators to bankers under their jurisdiction guarantees rapid, informed and appropriate reactions to problems and to changing local needs.

. Innovation--The creative tension between the systems of state and federal institutions has led to innovation in legislation and regulation, with state systems serving as laboratories for change.

Thus, Congress has adopted a consistent and deliberate course of action to insure equality of competition and wide dispersion of control over financial resources.

Overview

Now is certainly an appropriate time for removal of excessive and burdensome regulatory controls, including elimination of overlapping and duplicative examination and supervisory reviews, especially between state and federal agencies. Some expansion of bank and bank holding company roles may be necessary to meet market challenges.

However, CSBS believes current market conditions dictate that now is not the time for major changes in regulatory structure. Financial institution management teams are and will be sufficiently challenged by current business conditions without adding to their problems by creating unfamiliar regulatory structures. Regulators, too, do not need to be diverted from the essential task of maintaining institutional safety and soundness. At this time, the illusion of progress through massive reorganization could have important real costs.

There are ways to truly lessen regulatory burden without disruption of bank or regulatory functions. We discuss below the benefits of establishing parity between state banking departments and the Office of the Comptroller of the Currency. The Conference does not accept the need for a complete rewriting of Section 4(c)(8) of the Bank Holding Company Act and will not treat at length the arguments for and against new powers as part of these comments. However, CSBS has adopted a policy (attached) which would endorse some expansion of bank holding company powers, following a weighing of public interest considerations.

The Need For Parity

Recognizing the value of the dual system, the Conference of State Bank Supervisors seeks to maintain state/federal checks and balances. Toward this end, the Conference is seeking to establish a parity between state banking departments and the Office of the Comptroller of the Currency.

The vital importance of a sound payment mechanism has led government agencies which charter banks--the Comptroller of the Currency and state bank supervisors--to require safety and soundness regulation and inspection for decades, consisting of 1) onsite examination of a bank's books and records, 2) promulgation of general rules to be followed by all banks being regulated, and 3) specific administrative decisions affecting structure; e.g., branch openings, mergers and acquisitions.

On a secondary level, banks do, of course, deal with many other federal agencies, the two most prominent of which are the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve System (FRS). The FDIC has an insurer's interest in the safety of bank deposits and a liquidator's role under federal and many state statutes. The FRS, in addition to its vital role in determining and carrying out monetary policy, regulates to some degree the approximately 1,000 commercial banks which are state-chartered members of the FRS.

To avoid wasteful duplication of efforts and to maintain a viable, decentralized dual banking system requires the recognition of state banking departments and the Comptroller of the Currency as the primary regulators of respective state and national banks. The Federal Deposit Insurance Corporation and the Federal Reserve System, in keeping with their specialized roles, should exercise examination/supervisory responsibility only as extensions of and necessary complements to the primary regulators and should not discriminate against the state system. The current level of presence of the FDIC and the Fed in the examination and regulation of state-chartered banks is a wasteful use of banks' and taxpayers' funds and an unjustified incursion into the proper responsibility of the states.

The most significant feature of duplication and redundancy in bank supervision is the double track that each state-chartered institution must follow in regulation and examination, as well as in control of market entry and expansion. Almost step for step, a state-chartered bank has to follow a similar and largely redundant track with either the FDIC or the FRS. In contrast, national banks are regulated by only a single entity, the Comptroller of the Currency. Although all national banks are insured by the FDIC and all are required by law to be members of the FRS, neither the FDIC nor the FRS routinely is involved in the supervision and regulation of national banks. The FRS and FDIC basically accept the recommendations, opinions and examination findings of the Comptroller in meeting their responsibilities. States generally believe that the FRS and FDIC should accord them the same recognition as the Comptroller in carrying out their functions. This would mean a stepping back by these specialized federal agencies from their involvement in examination, regulation and the approval process of applications for state-chartered banks and some increase in their regulatory presence with national banks.

In January 1981 the General Accounting Office completed a report entitled, Federal Examination Of Financial Institutions: Issues That Need To Be Resolved. This GAO study goes to some length in detailing the duplication in the examination of financial institutions by state and federal agencies. It recommends greater reliance by the federal agencies upon the state reports. Another analysis completed in 1980 was State and Federal Regulation of Commercial Banks, by Leonard Lapidus and others, under the general sponsorship of the Federal Deposit Insurance Corporation. Dr. Lapidus, functioning as a quasi-independent contractor, also recommended increased reliance upon the work product of the state banking departments.

The current approaches to a phased reduction of the federal presence deserve mention. The divided examination program is designed to reduce redundancy, but retains for the FDIC a far greater role in the examination and regulation of state-chartered banks than for national banks. Twenty-six states currently are active in the divided examination program or are in the process of becoming so.

Under the accompanied examination approach, a single federal examiner accompanies each state examination team to perform necessary federal compliance oversight and as an "on the ground" observer of each bank. The federal examiner does not prepare a separate report, but addresses items of interest in a separate letter to the bank. This high degree of reliance on the state examination, with federal agencies concerning themselves only with specific interests, seems to provide the best avenue toward eventual total acceptance of the state examination, statutory authority for which exists for both the FDIC and the Fed.

CSBS believes that Congress should mandate a five year phase-in period for such acceptance, absent a showing on a state-by-state basis of why the state examination is insufficient. Ideally, at the end of such a phase-in period, the federal presence would be appropriately reduced to reflect specific agency interests in both insured state and national banks. A significant reduction in FDIC involvement in regulation and supervision could be effected thereby.

In addition, in the interests of economy and efficiency, the FDIC should accept the determination of the state supervisor, as it now accepts a decision of the Comptroller, in routine branch and headquarter relocation applications.

Duplicative supervision of state banks should be reduced, with the role of the FDIC limited to that amount of examination and supervision of both state and national banks necessary to preserve the integrity of the insurance fund. Such a reduction in the FDIC's role in state bank examinations would eliminate duplicative examinations, reduce expenses and allow the FDIC to increase its insurance reserves to protect depositors of failed banks. In addition, the FDIC's resources could then be used to better represent the insurer's interest in troubled national banks. The release of Fed personnel and resources to pursue monetary policy goals will be discussed below, although it is apparent the benefits would parallel those to the FDIC.

These proposals would require a transition period as some states would need time to build capability and to enact appropriate legislation. A progressive implementation of the transition plan over a known period would permit the states, FDIC and FRS to more efficiently use their resources to improve regulation of all banks, and especially troubled banks, in an orderly fashion. For these reasons these proposals should be implemented on a five year timetable ending December 31, 1988.

Cost Savings With Parity--A $ Estimate

If an accompanied program such as that described in the previous section were adopted, the annual net savings when the program was fully implemented would be approximately $35 to $40 million, at the current level of regulatory costs. Achievement of this net savings recognizes and accounts for the costs of ongoing FDIC accompanied examination programs for both state and national banks as well as all increased costs at the state level. Calculation of cost estimates based on current federal and state examination times, employee' reimbursement and incidental expenses are detailed below.

If over a five year mandated phase-out period the FDIC were to stop conducting their own full examinations of insured nonmember commercial banks and of state mutual savings banks and accept instead state examinations, it would save approximately $58.3 million a year on routine examinations. In order to meet any specialized insurance needs, the FDIC would spend a total of approximately $16.6 million a year on examinations in which FDIC examiners accompany state bank examiners and the Comptroller's examiners for a net savings to the FDIC of about $41.7 million per year. (The $16.6 million estimated cost of accompanied examinations consists of $1.3 million for state member banks, $8.6 million for nonmember banks, $5.8 million for national banks, and $800,000 for mutual savings banks.) The increased cost to state banking departments of examining banks now in the divided program would be approximately $14 million a year. The net savings to all federal and state bank supervisory agencies under this scenario would be about $27.7 million per year.

Similar savings would result from a phase-out of separate examinations by the Federal Reserve. Routine Federal Reserve examinations of state-chartered member banks cost approximately $12 million per year, if annual examinations are conducted. If the Fed were to cease its bank examination activities, state banking departments would have to spend an additional $1.5 million a year to examine banks now in the alternate program. The net savings to bank supervisory agencies would be approximately $10 million a year.

Savings to the private sector would also be substantial. In commenting on the effect of multiple, full-scale examinations by both the state and federal authorities, the GAO pointed out that such examination "unnecessarily distracts bank employees from performing their day-to-day operations." These "distractions" result in massive losses of bank staff man-hours to aid federal bank examiners, to meet reporting requirements and to answer follow-up inquiries.

The Fed, The States And The BHC Act

Historically, the initiative for the regulation of bank holding companies, like most banking innovations, originated at the state level. It was not until the 1930s that instability within the banking structure caused bank holding companies to become a federal concern. By then, three states already had statutes dealing specifically with the regulation of holding companies and six states actually prohibited banks from owning shares in other banks.

While the Banking Act of 1933 contained provisions dealing with bank holding companies, it was not until the Bank Holding Company Act of 1956 (Act) that extensive federal control was instituted. Then, and subsequently when the Act was amended in 1966 and 1970, Congress consistently reserved the right of the states to prohibit the formation of bank holding companies within their boundaries and to prohibit certain of their activities despite rulings by the Federal Reserve Board that they were permissible.

Eventually, through the 1970 amendments, the Act became the vehicle for a limited mixing of banking and commerce. Yet, this evolving structure, as overseen by the Fed working in partnership with the states, reinforced the principle of separation by providing a control mechanism to assure the safety and soundness of the banking industry while allowing a limited mixing of banking and commerce.

The principal form of that reinforcement was the distinction that was created between the bank subsidiaries of a holding company under Section 3 of the Act and its non-bank subsidiaries under Section 4. Under the Bank Holding Company Act, the Federal Reserve Board is the primary caretaker of that distinction, having been charged with administering the permissible activities test under Section 4. The states, through the general reservation of power contained in the Act, remain the final check on permissible activities within their respective borders.

The current statutory arrangement has great merit. The Federal Reserve Board is best suited among federal agencies because it has both the scope of perspective and the information at hand to be able to gauge the risk involved in mixing banking and commerce. Neither financial institution chartering or insuring agencies nor investment and commerce regulatory authorities would be a proper repository for this responsibility. The Board is already focused on the interrelationship of the financial and commercial sectors as a result of its central bank and monetary policy functions. The health of the economy and the safety and soundness of the nation's financial system are both within the Board's ambit.

The states share many of these goals with the Board, but, in keeping with American federalism, are focused at the local level. The role of the states with regard to the banking and holding company structure is to ensure that the broad policy directions determined by the Board to be in the national interest do not adversely impact on individual state economies or financial institution structure. Congress reinforced this concept by including in the Act not only the general reservation of state authority in Section 7, but the Douglas Amendment to Section 3 as well.

Notwithstanding the above role, the "hands on" examination of state-chartered banks should be reduced through the parity timetable previously described. Implementation of such a phase-out would lessen regulatory burdens on banks while still preserving an important national policy role for the Fed. CSBS believes the Board, whenever possible, should make use of the examination reports of state and federal chartering agencies.

Effect on State-Chartered Banks

Currently, 71% of all banks are state-chartered and these institutions hold approximately 50% of all bank assets. Contrary to the general assumption, state-chartered banking is not concentrated primarily in small banks. While it is true that the average size of state-chartered banks is smaller than that of national banks, of the 50 largest banks in the United States one-third are state-chartered.

Lifting the regulatory burden of duplicative supervision would, in fact, be a major accomplishment. Our conservative cost estimates show that substantial sums could be saved. However, such an accomplishment would not be worth the loss of public benefits should other recommendations of the Task Group weaken the dual system by removing its underpinnings. It is also important that the Task Group not attempt to define the appropriate regulatory framework before the institutional structure to be regulated has been determined. Legislative recommendations which fail to reasonably reflect current market conditions as well as trends gather dust in the file cabinets of numerous Capital offices.

As stated, Congress has adopted a clear and consistent national policy of avoiding excessive concentrations of economic and financial resources. That principle is a cornerstone of the dual banking system. While value judgments must always be made as to questions of degree in applying such broad policies, the Conference would balk at any suggestion that a reappraisal of that policy is in order.

For these reasons, in addition to submission of written comments, I and the CSBS staff stand ready to give whatever further assistance you may need on this matter. Such cooperative effort might help to overcome the unfortunate absence of state regulators on the Task Group.

Sincerely,

Sidney A. Bailey

Sidney A. Bailey
President

SAB:drj

Attachment

CSBS POLICY ON SEPARATION OF BANKING AND COMMERCE

(Approved January 8, 1983 by the CSBS Board of Directors)

Introduction

The Conference of State Bank Supervisors (CSBS)--made up of the 53 state bank supervisors who charter and who are the primary examiners, regulators and supervisors of the approximately 10,500 state chartered banks holding nearly one-half of all bank assets of the nation--has a vital interest in and public responsibility toward the concept of the separation of banking and commerce. Therefore, CSBS adopts the following policy guides:

Banking and Commerce Relationship Criteria

In matters relating to the separation or mixing of banking and commerce, the following concepts shall guide CSBS actions:

1. In as much as economic, political and geographic circumstances vary from state to state, emphases appropriately placed on each criteria by each respective state relative to the mixing of banking and commerce will also vary. To serve best the public interest, CSBS criteria and the application thereof on a case-by-case basis will accommodate to this diversity.

2. In as much as a primary goal of CSBS policies and actions is to encourage banks to provide needed financial services, CSBS encourages flexibility in banking powers and services to the full extent consistent with bankings' primary functions, responsibilities and roles in the economy.

3. In as much as banks, along with certain other depository institutions, have traditionally been recognized as unique in that they broadly assemble funds from essentially one and all in respective trade areas and provide demand deposit services required for day-to-day transactions, banks have a public trust which demands that safety and soundness continue to be emphasized.

4. These same characteristics which bestow on banks a public trust also demand that banks be without conflicts of interest and bias in allocating financial resources entrusted to them.

5. In as much as "money" inherently is vulnerable to concentration and centralized control with possible abuses attendant thereto and for all practical purposes has no near substitute, the public interest demands that undue concentrations of banking with commerce be avoided.

6. In as much as money has an inherently unique power, only financial activities which are appropriate adjuncts to providing financial services, with emphasis on the criteria set forth in 3, 4 and 5 above, should be "mixed" with banking.

7. Equitable treatment should be evaluated on an overall basis and not misconstrued or confused with equal or sameness of services and powers: banks remain distinct in fundamental, public interest ways from other financial institutions notwithstanding recent legislation.

   Therefore, in order for the banking system to compete equitably with other types of institutions, banking should be granted certain new powers or other types of institutions denied certain powers in those circumstances in which inequity exists. Competitive inequity can adversely affect safety and soundness.

8. To the extent new powers may be granted to banks to provide needed services or to permit banks to compete equitably, appropriate quantitative and/or qualitative limitations should be established to assure safety and soundness, unbiased allocation of financial resources and freedom from undue concentrations of financial or economic resources.

In summary, CSBS believes greater flexibility may be needed in selected areas (criteria 1 and 2), certain public interest guides must be respected (criteria 3 through 7) and to the extent any essential flexibility may be inconsistent with one or more broader public interest guides, definitive limitations must be imposed (criterion 8).

To the extent any two or more of the above criteria may be inconsistent with one another when applied to specific situations, each proposed service or power must be weighed by CSBS against subject criteria and a judgment reached as to a maximization of the public interest or the least imperfection in serving the public interest.

CONFERENCE OF STATE BANK SUPERVISORS
CSBS

OFFICE OF THE EXECUTIVE VICE PRESIDENT-ECONOMIST

April 12, 1983

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Director
Bank Organization and Structure
Office of the Comptroller of the Currency
490 L'Enfant Plaza East, SW
Washington, D.C. 20219

RE: Application(s) to Organize a Holding Company to Include 31 National Banks to be Known as Dimension Bank of (various cities), National Association

Gentlemen:

The Conference of State Bank Supervisors (CSBS) appreciates this opportunity to comment to the Office of the Comptroller of the Currency (OCC) on subject application(s). CSBS is the professional organization of state officials who are the primary chartering, examination, supervisory and regulatory authorities for approximately three-fourths of all banks holding nearly one-half of all bank assets in the United States. As such, CSBS has a vital interest in subject application(s).

It is our understanding that subject holding company has been incorporated in Delaware, has been organized primarily by persons from Kansas with oil, gas and savings and loan interests in Kansas, would have its headquarters office in Colorado, plans to establish, own and operate 31 so-called "nonbank banks" in 25 states and we must assume has intentions to seek subsidiaries or entities with powers beyond those disclosed in subject application(s). In instant application(s), each bank would be a wholly owned subsidiary of Dimension Financial Corporation (Dimension), a holding company with organizational characteristics and operating capabilities essentially like existing holding companies which must function under the public interest and Congressionally mandated disciplines of the Bank Holding Company Act of 1956, as amended.

CSBS strongly opposes subject application for at least five reasons: lack of legal authority, contravention of the intent of Congress, undisclosed intentions, violation of the public interest and lack of significant redeeming merits.

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1. Legal Authority

It appears that subject application(s), if approved, would be in violation of the Bank Holding Company Act and be contrary to various state laws which are binding upon federal bank regulatory agencies under Section 7 of the Bank Holding Company Act. CSBS is fully supportive of related actions by individual state supervisors. The attached letter from our legal counsel, Jones, Day, Reavis and Pogue, cites the legal basis for this position.

2. Intent of Congress

Dimension by subject application(s), and others who foster similar action apparently disregard Congressional intent as expressed relative to and in the Bank Holding Company Act to place holding company regulation under the jurisdiction of the Federal Reserve Board (FRB) and to grant individual states the authority to specify conditions under which out-of-state holding companies may establish, own and operate banks within their borders.

The proposed circumvention of the intent of the Act derives from the definition of "bank", as used therein, as an institution which both accepts deposits that are available on demand and engages in the business of making commercial loans. In order to use this alleged loophole, Dimension is seeking to avoid one of the necessary elements of the definition, i.e., not make commercial loans.

The FRB rightfully has expressed great concern over attempted uses of this alleged legal loophole to escape the Federal Reserve's regulatory responsibilities under the Act. During December 1982, the FRB voiced objection to applications pending before both the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency. Embodied in the FRB objection was a restatement of a previously articulated policy that any loan other than a loan the proceeds of which are used to acquire property or services used by the borrower for personal, family, household or charitable purposes constitutes a commercial loan. This definition of a commercial loan includes such items as the purchase of commercial paper, bankers acceptances, certificates of deposit, the extension of broker call loans, sales of federal funds, deposits of interest bearing funds and similar lending vehicles.

It is the predominant view of state bank supervisors that the proposed Dimension banks would, in fact, be banks under every practical application of the concept of banking and that public interest considerations as clearly intended by Congress dictate that subject application(s) come before the FRB for decision under the provisions of the Bank Holding Company Act. CSBS is supportive of the clear intent of Congress on this issue.

3. Undisclosed Intentions

Subject application(s) apparently do not disclose any intentions of Dimension Financial Corporation to establish other subsidiaries or entities which might, in fact, make commercial loans through indirect means or which might exercise powers, directly or indirectly, beyond those set forth in the Bank Holding Company Act or by Federal Reserve regulations, as amended or to be amended. Approval of Dimension application(s) would lay the groundwork for the implementation of broader powers than disclosed in subject application(s) thus resulting in a compounded violation of the clear intent of Congress.

4. Vital Public Interest Concepts

Individuals or groups promoting exploitation of the possible loophole in the "nonbank bank" concept repeatedly have shown a disregard or lack of awareness of certain well established public interest concepts.

a. Safety and Soundness

The whole issue of safety and soundness has been largely disregarded in the "nonbank bank" approach. In enacting the Bank Holding Company Act, Congress was clearly concerned about safety and soundness from both regulatory and operational standpoints. The Act was designed to assure a presence of federal and state authorities over organizations with characteristics of the proposed Dimensions. For purposes of the limited mixing of banking and nonbanking activities, Congress specified that nonbanking activities must fulfill the test of being closely related and a proper incident to banking to obtain regulatory approval. The "nonbank bank" phenomenon opens the way to a freewheeling mixing of activities outside the statutorily prescribed scheme. Thus, the Dimension proposal represents an undisciplined undermining of the safety and soundness of the banking system.

Banks, more than any other type of institution, must maintain safety and soundness. Banks are the major source of demand deposit services necessary for daily transactions. Disruptions or terminations of these vital banking services have a more devastating impact on the entire economy of a trade area than do failures of other businesses.

b. Financial Power Concentration and Centralized Control

Further, unrestrained loophole actions of the "nonbank bank" type are particularly dangerous in view of the facts that "money" inherently is vulnerable to concentration and centralized control with all the historically experienced abuses attendant thereto and that "money" for all practical purposes has no near substitute. It is a matter of record that concern over financial power concentration was very much in the minds of Congress when statutes most relevant to subject case were enacted.

Of course, subject proposal of itself might not lead to nationwide concentrated power abuse. Acceptance of the concept as national policy, however, would.

National policy changes should be based on demonstrated need. There is no demonstrated need to centralize and concentrate our nations' banking system. To the contrary, we have an excellent balance of large, medium and small banks which together provide a better package of diverse banking services for diverse needs of customers than any other system in the world.

c. Conflicts of Interest in Financial Resource Allocation

Finally, acceptance of the "nonbank bank" concept inevitably would lead to conflicts of interest in the allocation by banks of financial resources. Notwithstanding recent legislation, banks are unique in that they have primary responsibilities of broadly assembling financial resources from one and all in respective trade areas of all sizes and of reallocating these funds. These dual qualities--assembling and allocating--bestow on banks a public trust to be without conflict of interest and bias in the allocation back to the economy of financial resources entrusted to them. Acceptance of the "nonbank bank" loophole inevitably would lead to an unchecked mixing of banking and commerce. This, in turn, would destroy that great public interest role of banking to allocate a large proportion of the financial resources of each trade area without conflict of interest or bias.

5. Lack of Redeeming Merits

In subject application, as in the broader practice of "nonbank bank" loophole exploitation, there are many public interest disadvantages but no significant redeeming advantages. The interests of a small minority who want to centralize and concentrate financial and economic power as an end in itself are about all that would be served by this exploitation.

That, in summary, is the reason why subject application(s) should be disapproved or deferred pending (a) a conscious decision by Congress to endorse the "nonbank bank" loophole or (b) court determination of the intent of Congress in enacting the Bank Holding Company Act and amendments thereto.

The OCC has declared a moratorium until January 1, 1984 on future applications for "nonbank bank" charters or acquisitions. For reasons of public policy and fair treatment, the Dimension and similar pending applications should also be subject to this moratorium.

Request for Hearing

CSBS requests that a public hearing be held to determine (a) intentions of organizers to establish subsidiaries or entities other than the 31 formally disclosed, (b) intentions to exercise now undisclosed powers directly or indirectly through the proposed 31 subsidiaries or through subsidiaries or entities to be formed at a later date, (c) anticipated flows of funds between the 31 subsidiaries and between subsidiaries and the parent holding company, (d) withdrawals of financial resources from and/or capital infusions into respective trade areas, (e) services other than financial, as responsible corporate entities, to respective trade areas and (f) the relevance of federal and state statutes to the overall application and to each of the 31 applications in 25 states.

CSBS requests an opportunity to testify on subject case.

Sincerely,

Lawrence E. Kreider
Lawrence E. Kreider
Executive Vice President-Economist

Enclosure

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April 8, 1983

Dr. Lawrence E. Kreider
Executive Vice President-Economist
Conference of State Bank Supervisors
1015 Eighteenth Street, N.W., Suite 606
Washington, D.C. 20036

Re: Dimension Financial Corporation

Dear Larry:

You have asked us to consider the applications filed by Dimension Financial Corporation ("Dimension") with the Office of the Comptroller of the Currency ("OCC") to establish a network of thirty-one national banks in twenty-five states, in light of the provisions of the Bank Holding Company Act, 12 U.S.C. §§ 1841-1850 (the "Act"). While we have not had the opportunity to review all of these applications in detail, we understand that, in general, each application contemplates the establishment of a national bank which will offer regular checking (demand deposit) and NOW (negotiable order of withdrawal) accounts, savings accounts, money market deposit accounts and certificates of deposit, consumer loans, real estate and home improvement loans, and trust services. Each bank will also hold investment securities, "cash and due from banks" and, potentially, "financial instrument futures contracts and alternative investment vehicles." Each application claims, however, that "[t]he proposed bank does not plan to engage in the business of making commercial loans." 1/

We understand that Dimension is a Delaware corporation with its principal business offices in Denver, Colorado. 2/ Dimension

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1/ *See*, *e.g.*, Application by Dimension to charter Dimension Bank of Atlanta, National Association, accepted for filing by the OCC on March 3, 1983, at 34-39, 47-50, 58-59, 65-66.

2/ *Id.* at 90.

has filed applications with the OCC to establish single banks in each of twenty-three states and four banks in each of Florida and Texas.

Based upon our initial review of the Dimension applications, it appears that the establishment by Dimension of the proposed national banks would violate the Act in three respects:

(1) The proposed banks may well be "banks" for purposes of the Act and, if so, may not be acquired by Dimension without the prior approval of the Federal Reserve Board (the "Board") under Section 3 of the Act, 12 U.S.C. § 1842;

(2) Dimension may not establish the proposed banks in more than one state without express state permission under Section 3(d) of the Act, 12 U.S.C. § 1842(d) (the "Douglas Amendment"); and

(3) To the extent that state law prohibits the establishment by Dimension of certain of the proposed banks, such prohibitions are binding upon the federal bank regulatory agencies under Section 7 of the Act, 12 U.S.C. § 1846.

The reasons for each of the foregoing conclusions are set forth below.

1. The Establishment by Dimension of the Proposed National Banks Requires the Prior Approval of the Board

Section 3(a) of the Act provides that "[i]t shall be unlawful except with the prior approval of the [Federal Reserve] Board, (1) for any action to be taken that causes any company to become a bank holding company; [or] (2) for any action to be taken that causes a bank to become a subsidiary of a bank holding company . . . ." Since Dimension will own all of the shares of each of the thirty-one proposed banks, it is clear that Dimension will be a "bank holding company," and that each bank will be a "subsidiary" thereof, if the proposed banks are deemed to be "banks" for purposes of the Act. 3/ Thus, if the proposed banks fall within

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3/ See Section 2(a)-(d) of the Act, 12 U.S.C. § 1841(a)-(d).

the definition of "bank" under Section 2(c) of the Act, they may not be established by Dimension without the prior approval of the Board.

a. The Definition of "Bank" under Section 2(c)

Section 2(c) defines "bank" to include "any institution . . . which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans." As originally adopted in 1956, Section 2(c) defined "bank" to include "any national banking association or any State bank, savings bank or trust company . . . ." 4/ Section 2(c) was amended in 1966 to define "bank" as "any institution that accepts deposits that the depositor has a legal right to withdraw on demand"; the purpose of the 1966 amendment was to exclude savings banks and similar institutions from coverage under the Act. 5/ In 1970, Section 2(c) was further amended by adding the reference to commercial loans. The intent of this amendment, as explained by Congress and the Board, was to ensure that only those institutions which "engaged in commercial banking" would be subject to the provisions of Section 3. 6/ The Board explained to Congress that "this amendment would have very limited application at present, possibly affecting only one institution." 7/ For its part, Congress instructed the Board to

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4/ Act of May 9, 1956, c. 240, § 2(c), 70 Stat. 133. See S. Rep. No. 1095, 84th Cong., 1st. Sess. (1955), reprinted in [1956] U.S. Code Cong. and Admin. News 2482 at 2489.

5/ Act of July 1, 1966, Pub. L. No. 89-485, § 3, 80 Stat. 236. See S. Rep. No. 1179, 89th Cong., 2d Sess. (1966), reprinted in [1966] U.S. Code Cong. & Admin. News 2385 at 2391.

6/ Act of Dec. 31, 1970, Pub. L. No. 91-607, § 101, 84 Stat. 1760. See S. Rep. No. 1084, 91st Cong., 2d Sess. (1970), reprinted in [1970] U.S. Code Cong. & Admin. News 5519 at 5541.

7/ One-Bank Holding Company Legislation of 1970: Hearings on Bills to Amend the Bank Holding Company Act of 1956 before the Senate Comm. on Banking and Currency, 91st Cong., 2d Sess. (1970) ("1970 Senate Hearings") at 136-37 (Letter from

[Footnote continued on next page]

construe the Section 2(c) "exemption" for banks which did not make commercial loans "as narrowly as possible in order that all bank holding companies which should be covered under the Act in order to protect the public interest will, in fact, be covered." 8/

In accordance with Congress' instructions, the Board has adopted a strict construction of the meaning of "commercial loans" in Section 2(c). In interpretive letters issued in December 1982, the Board declared that the term "commercial loan" includes "any loan other than a loan the proceeds of which are used to acquire property or services used by the borrower for personal, family, household or charitable purposes." Accordingly, the Board said that the sale of federal funds or the purchase of commercial paper, bankers acceptances or certificates of deposit or the use of "similar lending vehicles" would constitute "commercial loans," because such transactions "would establish a debtor-creditor relationship between business enterprises." 9/

The applications filed by Dimension indicate that the proposed banks will engage in activities which appear to fall within the Board's definition of "commercial loans." For example, the Dimension Bank of Atlanta, N.A. expects to maintain "cash and due from banks" in an amount equal to eight percent of its total deposits, a percentage which it acknowledges is higher

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[Footnote continued from previous page]

J. L. Robertson, Vice Chairman of the Board, to Senator Sparkman). The "one institution" which the Board referred to was evidently the Boston Safe Deposit and Trust Company. See 116 Cong. Rec. S 6908, S 6911 (daily ed. May 11, 1970) (remarks of Senator Brooke re introduction of S. 3823); 116 Cong. Rec. S 20642 (daily ed. Dec. 18, 1970) (remarks of Senator Sparkman); Letter dated May 18, 1972 from M. A. Greenspan, Assistant Secretary of the Board, to L. J. Aubrey, Vice President of the Federal Reserve Bank of Boston.

8/ Conf. Rep. No. 1747, 91st Cong., 2d Sess. (1970), reprinted in [1970] U.S. Code Cong. & Admin. News 5561 at 5573-74.

9/ Letter dated Dec. 10, 1982 from W. W. Wiles, Secretary of the Board, to W. M. Isaac, Chairman of the FDIC, re Lincoln State Bank; Letter dated Dec. 16, 1982 from W. W. Wiles to J. Diamond re Lincoln State Bank and Dreyfus National Bank. See 39 Wash. Fin. Rep. 1136 (Dec. 20, 1982).

than customary. Presumably, "cash and due from banks" could include federal funds sold to, or certificates of deposits purchased from, other banks. In addition, the Bank intends to invest significant amounts in "investment securities" and may decide to invest in "financial instrument futures contracts and alternative investment vehicles." 10/ Depending upon the actual facts concerning the intended operations of Dimension's proposed banks, it seems probable that such banks will engage in transactions (including transactions with affiliated banks and nonbanking entities) which create a "debtor-creditor relationship between financial enterprises," and which constitute "commerical loans" within the meaning of Section 2(c).

Thus, it will be necessary for the OCC to conduct a hearing pursuant to 12 C.F.R. §§ 5.10 and 5.11 in order to determine with precision the nature and extent of each business activity which the Dimension banks propose to engage in, and whether any such activity would fall within the Board's construction of the term "commercial loans." In particular, such hearing should focus on potential transfers of funds and other transactions among the proposed Dimension banks and affiliated nonbanking entities (especially any such entities which intend to engage in commercial lending activities).

b. The Authority of the Board to Define "Commercial Loans" for Purposes of Section 2(c)

It is clear that the OCC must defer to the Board's definition of "commercial loans" for purposes of Section 2(c) of the Act. First, as already noted, Congress has given to the Board the responsibility of construing the exemption contained in Section 2(c) "as narrowly as possible" in order to ensure that all holding companies which should be treated as bank holding companies under the Act are so treated. 11/ Second, under Section 5(b) of the Act, 12 U.S.C. § 1844(b), "the Board is authorized to issue such regulations and orders as may be necessary to enable it to administer and carry out the purposes of [the Act] and prevent evasions thereof." Thus, the Board's interpretive rulings issued in December 1982 regarding the definition of "commercial loans," which were issued in order to prevent evasions of the Act

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10/ *See* Application, *supra* note 1, at 37, 47, 66.

11/ Conf. Rep. No. 1747, *supra* note 8, at 5573-74.

under the guise of Section 2(c), plainly carry the authority of Congress and must be followed by the OCC. 12/

Finally, the Supreme Court has repeatedly recognized the Board as the agency having primary responsibility for administering and interpreting the Act, and has held that the Board's determinations are binding upon the OCC. 13/ In Whitney National Bank, 379 U.S. at 419, the Court declared that "Congress intended the statutory proceedings before the Board to be the sole means by which questions as to the organization or operation of a new bank by a bank holding company may be tested," and that "Congress had no intention to give the Comptroller a veto over the Board in such cases."

In sum, a full hearing by the OCC is required to determine whether, as it appears, the proposed Dimension national banks will engage, either directly or indirectly through nonbanking affiliates, in business activities falling within the term "commercial loans" as construed by the Board. Additionally, the OCC must defer to any proceedings which may be conducted by the Board to determine whether such banks are "banks" within the meaning of Section 2(c). If the answer is affirmative in either case, the proposed Dimension banks may not be established without the prior approval of the Board.

2. The Douglas Amendment Prohibits Dimension from Establishing the Proposed Banks in More than One State without Express State Permission

Since it appears that the proposed national banks are "banks" within the meaning of Section 2(c), the Douglas Amendment prohibits Dimension from establishing such banks in more than one state without specific state authorization. Under the Douglas Amendment, Dimension is required to select one state (presumably Florida or Texas) where the operations of its subsidiary banks would be "principally conducted" (*i.e.*,

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12/ *Wilshire Oil Co.* v. *Board of Governors of Federal Reserve System*, 668 F.2d 732 (3rd Cir. 1981), *cert. denied*, 102 S. Ct. 2958 (1982).

13/ *E.g.*, *Whitney National Bank* v. *Bank of New Orleans & Trust Co.*, 379 U.S. 411 (1965). *First Lincolnwood Corp.* v. *Board of Governors of Federal Reserve System*, 439 U.S. 234 (1978).

where Dimension's banks would have the largest total deposits), and Dimension may not establish a bank in any *other* state unless the acquisition of "a State bank by an out-of-State bank holding company is specifically authorized by the statute laws of the State in which such bank is [to be] located, by language to that effect and not merely by implication."

Even assuming that the proposed national banks are *not* found to be "banks" within the meaning of Section 2(c), the policy and manifest intent of the Douglas Amendment would nevertheless bar the establishment of such banks in more than one state without express state statutory permission. When the Douglas Amendment was adopted in 1956, the term "bank" as used therein was defined to include "*any* national banking association or any State bank, savings bank or trust company." 14/ Senator Douglas declared that his amendment was designed to "prohibit bank holding companies from purchasing banks in other states unless such purchases by out-of-State holding companies [are] specifically permitted by law in such States." Senator Douglas further explained that his amendment was "a logical continuation of the principles of the McFadden Act, which tried to prevent the Federal power from being used to permit national banks to expand across State lines in a way contrary to State policy . . . ." 15/

Thus, the clear intent of Congress in adopting the Douglas Amendment was to prohibit holding companies from acquiring institutions chartered as banks -- including those chartered as national banks -- in more than one state without specific state authorization. Moreover, Congress viewed the Douglas Amendment as a means of ensuring that national banks could not expand across state lines in violation of the McFadden Act, 12 U.S.C. § 36.

The establishment of the Dimension bank network would violate the plain congressional policy and intent embodied in the Douglas Amendment. Approval of the Dimension applications would result in a single holding company having control over thirty-one chartered national banks in twenty-five different states. Moreover, it is obvious from the Dimension applications that the various subsidiary banks will be operated in an integrated and

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14/ Act of May 9, 1956, *supra* note 4, §§ 2(c) and 3(d) (emphasis added).

15/ 102 Cong. Rec. 6860 (April 24, 1956).

unitary fashion by the parent holding company, thereby resulting in the creation of an interstate de facto branch network contrary to the policy of the McFadden Act. 16/

This patent violation of the essential purpose of the Douglas Amendment cannot be excused merely by reference to Congress' amendment of the definition of "bank" in 1970. As shown above, Congress believed that the amendment would have "very limited application" -- probably with respect to only one institution -- and would not diminish the coverage of the Act in any material way. 17/ Congress neither intended nor foresaw that the 1970 amendment of Section 2(c) could be relied upon to justify the creation of an extensive interstate network of national banks such as the one proposed by Dimension.

In these circumstances, the Douglas Amendment bars the establishment by Dimension of the proposed national banks in more than one state without specific state authorization. Under established canons of statutory construction, the literal terms of Section 2(c) may not be used to justify a result which is "plainly at variance with the policy of the legislation as a whole," and the manifest purpose of the Douglas Amendment must be upheld. Wilshire Oil Co., 668 F.2d at 735-36, quoting United States v. American Trucking Ass'ns., 310 U.S. 534, 543 (1940).

3. State Laws Which Prohibit the Establishment of Proposed Dimension Banks Are Binding upon the OCC

We understand that in several states there may be state statutes, judicial decisions or authoritative administrative interpretations which prohibit the establishment by Dimension of

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16/ See Application, supra note 1, at 65-66, 75-85. See also Michigan National Corp., 64 Fed. Res. Bull. 127 (1978), appeal dismissed, No. 78-3057 (6th Cir. July 2, 1979). Since each of the proposed Dimension national banks will accept deposits, pay checks and make loans, their activities will fall within the definition of "branch" activities under 12 U.S.C. § 36(f). First National Bank in Plant City v. Dickinson, 396 U.S. 122 (1969).

17/ 1970 Senate Hearings, supra note 7, at 137; Conf. Rep. No. 1747, supra note 8, at 5573-74.

one or more of the proposed national banks. Such prohibitions are binding upon the OCC under Section 7 of the Act.

Section 7 reserves to each state, notwithstanding the provisions of the Act, the right of "exercising such powers and jurisdiction which it now has or may hereafter have with respect to banks, bank holding companies, and subsidiaries thereof." The legislative history and judicial interpretations of Section 7 establish that the states may adopt measures with respect to holding companies which are more restrictive than the Act, so long as such measures are not in violation of the U.S. Constitution. 18/ For example, the states may prohibit acquisitions of banks by bank holding companies in circumstances where such acquisitions would otherwise be permitted by the Act. 19/

In addition, Congress' adoption of the Douglas Amendment at the same time it adopted Section 7 reflects a strong congressional policy in favor of state control over banking structure. Accordingly, it is our view that state law prohibitions against the establishment by Dimension of one or more of the proposed national banks would be binding upon the OCC under Section 7.

Conclusion

Based upon the foregoing, it appears that:

(1) A full hearing must be conducted by the OCC to determine whether the proposed national banks will engage in activities which would cause them to be "banks" under the Board's authoritative interpretation of Section 2(c) of the Act. If so, such banks may not be established by Dimension without the prior approval of the Board.

18/ S. Rep. No. 1095, supra note 4, [1956] U.S. Code Cong. & Admin. News at 2492, 2504; Lewis v BT Investment Managers, Inc., 447 U.S. 27, 48-49 (1980); Braeburn Securities Corp. v. Smith, 15 Ill.2d 55, 153 N.E.2d 806 (1958), appeal dismissed, 359 U.S. 311 (1959).

19/ Commercial Nat'l Bank of Little Rock v. Board of Governors of Federal Reserve System, 451 F.2d 86, 89 (8th Cir. 1971); Braeburn Securities Corp., 153 N.E.2d at 810.

(2) Whether or not the proposed national banks are deemed to be "banks" for purposes of Section 2(c), the Douglas Amendment would prohibit the establishment of such banks by Dimension in more than one state without specific state statutory authorization.

(3) State law prohibitions against the establishment by Dimension of one or more of the proposed national banks would be binding upon the OCC under Section 7 of the Act.

Please contact us if you should have any questions concerning the foregoing matters.

Sincerely yours,

James F Bell

Arthur E. Wilmarth Jr.

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The Dynamic American Banking System—
An Analysis of
Geographic Structural Constraints

A Policy Study by the
Conference of State Bank Supervisors

April 1983

TABLE OF CONTENTS

Page

Executive Summary 1

Introduction 6

Section I: American Policies on Concentration 9

- A. Aggregate Concentration and Structural Diversity: Broad Considerations 10
- B. Aggregate Concentration, Structural Diversity, and Competition 11
- C. Effectiveness of American Policies on Concentration 16
- D. Safeguards Against Undue Concentration 20
- E. Summary 22

Section II: The American Banking System--A Framework 23

- A. Local Control 23
- B. Diversity 25
- C. Bank Structures In Selected Foreign Countries 27
- D. Duality 28
- E. National Focus 29

Section III: The Arguments For Change 32

- A. The "Market Share" Issue--Nonbank Competition 32
- B. "The Market Share" Issue--Thrift Industry Competition 34
- C. "Advantages" of Foreign Banks 36
- D. The "Service" Issue 37
- E. The Technology Issue 41
- F. Summary 44

Section IV: Conclusions 45

LIST OF TABLES

Table		Page
1	Commercial Bank Concentration	17
2	Percentage of Total Life Insurance Company Assets Held by Top n Life Insurance Companies	18
3	Percent of Value of Shipments Accounted For by The Four Largest Domestic Companies, by Year	19
4	Numbers of Commercial Banks And Concentration in Six Selected Countries	26

EXECUTIVE SUMMARY

Fundamental to the American banking system is a longstanding national policy which strives to limit the concentration of power over the nation's financial resources. The McFadden Act and the Douglas Amendment to the Bank Holding Company Act help implement this policy by giving to the various states the major role in determining the American banking structure. The Congress, over a 200 year history, has consistently reaffirmed its belief that decentralized control of structure provides the primary safeguard against undue concentration of financial resources and regulatory authority over those resources. By ensuring that the allocation of local resources is controlled by local markets and by local financial and political institutions, Congress has succeeded in dispersing the ownership and control of financial resources and the economic and political power which flows from them throughout society.

Aggregate concentration--the proportion of assets or output accounted for by the largest firms within the economy or some major sector thereof--has long been considered an important indicator of political and economic power. Aggregate concentration of financial resources in particular is to be shunned since the role of money as the medium of exchange for all commodities carries with it inordinate power.

The elimination of geographic constraints would not result in more competitive local structures and would increase the concentration of banking resources.

The three primary safeguards of our national policy against undue concentration in the commercial banking industry are: the McFadden Act and the Douglas Amendment to the Bank Holding Company Act; the antitrust laws; and the dual banking system.

The United States has the most diversified and decentralized banking system in the world. It was a series of Congressional actions--principally the McFadden Act and its amendments and the Douglas Amendment--that produced this system.

The interrelationship between the development of a nation's economy and its banking system is obvious. It is not coincidental that the United States, with a decentralized banking system that fosters creativity and innovation, has the most progressive and powerful economy in the world.

The antitrust laws are not responsible for the decentralized nature of the system. While enacted almost a century ago, antitrust laws were not applied to banking until 1960. The antitrust laws always have applied to most other industries yet, none of those industries approximate the 14,000 units that exist in commercial banking. Moreover, only the McFadden Act.and Douglas Amendment are available to limit market extension acquisitions. The Justice Department has been unsuccessful in preventing such acquisitions, having lost every commercial banking suit initiated under the potential competition doctrine.

There are several key aspects of the American banking system that contribute to its overall effectiveness: local control, diversity, competition and a national focus.

Local ownership of financial institutions, local determination of structure and local regulation have insured that the influence financial institutions exercise over the monetary activities of American businesses and individuals will be controlled essentially within the territories served. This is the essence of local control and forms one aspect of the dual banking system.

The development of diverse financial institutions occurs in three critical dimensions: size, scope of service, and structure. Units of all sizes comprise the American financial system; in commercial banking they range from over $100 billion down to a few million in assets. This great disparity in size contributes to the variety of services offered by different types of commercial banks.

Competitive innovation stems from the fact that the dual banking system provides the opportunity for the various states to serve as laboratories for change. Noted state initiatives include checking accounts, the NOW account, and shared EFT networks, but one could cite many others. The critical element has been a creative tension between the two systems--a sense of balance which leads to innovation and its diffusion.

A notable feature of our system is its broad national applicability. With respect to most facets of banking--corporate and retail alike--a financial institution with the resources and the commitment can offer its services nationwide.

Geographic constraints found in such legislation as McFadden and Douglas are not designed to prevent interstate activity. Rather, they are designed to prevent massive concentration of financial resources, to limit corporate ownership of banks and to insure local control.

The three major problems with the present structure advanced by proponents of full interstate bank ownership are that it is responsible for loss of market share, that it restricts provision of interstate banking services and that it limits the effective use of evolving technologies. In fact, as will be demonstrated, the latter two problems are illusory while the loss of market share is not the result of geographic disciplines contained in McFadden and Douglas.

Analysis of market share data indicates there is a correlation between interest rates paid by competing institutions and market share shifts for time and savings deposits. Little or no correlation, however, was found between changes in the total number of offices of competing institutions and such market share shifts. This suggests that disparities in interest rates are the problem requiring solution not geographic limitations.

Further support for this conclusion is provided when consideration is given to the impact recent bank money market deposit and Super NOW accounts authorized by The Depository Institutions Deregulation Committee have had on the market share of banks and money market mutual funds (MMMFs). The new high yield deposit instruments have attracted billions of dollars of deposits into these new accounts at banks, and there has been a significant reduction in the MMMF's share of this market.

The existing U.S. banking system has allowed banks and bank holding companies to provide a substantial variety and amount of services in other states. From the percentage of banks that have chosen to provide such services, it is clear that management decisions, not legal constraints, are the determining factor.

The emergence of electronic funds transfer (EFT) services offered by financial institutions to their customers wherever they are and whenever financial services are needed is a harbinger of electronic network banking. The technology exists today for statewide, regional, nationwide and even worldwide financial communication through electronic networks.

CSBS fully supports technological developments including shared ATM and bank card networks, pay by phone systems, and the like, as long as the shape of a system serving the people of a state is determined at the state level. This would insure (1) maintenance of the checks and balances in our state/federal system, (2) development of systems that will best meet diverse needs of particular states, and (3) access to systems by all institutions regardless of size. CSBS has encouraged states to enact legislation that will allow customers of local financial institutions to obtain financial services when they are away from their institutions and significant progress is being made.

Penetrating the McFadden and Douglas constraints of interstate bank ownership would affect the gathering of retail deposits by the commercial banking system. It would affect the establishment of a full-service presence--branches of commercial banks or bank subsidiaries of bank holding companies--by commercial banking organizations in more than one state. Considering the multiplicity of activities that already exists on an interstate basis, that may not seem very important. In reality, however, it would be a massive shift in national policy striking at the concepts of ownership and control of financial resource centers.

It is clear that the purpose behind suggested changes away from state determination of banking structure is not the provision of interstate bank services, but interstate ownership and control. Congress must broaden the debate over interstate ownership and control from the narrow--real as they may be--concerns advanced by proponents of change to the more fundamental issue: the concentration of financial resources. The consequences of major concentrations of ownership and control of banking resources must be considered with great care.

It is probable that the elimination of interstate restrictions would have a serious impact on the dual banking system. It is difficult to see how states would be able to sustain their unique banking structures or their authority over institutions. The principles embodied in McFadden and Douglas recognize that the individual states can best decide structural issues. To imply that one approach is optimal for all 50 states is to ignore the existence of our decentralized economic and political heritage.

All the evidence suggests that today's system serves the American businessman, corporation, and individual customer well. The financial needs of large American businesses are met by the major financial institutions; local banks afford small businesses excellent services, and above all and to a degree not found in other nations, the consumer enjoys a broad array of financial services. It is our view that the burden of proof that change is necessary in such a system lies with proponents of such change. This is particularly so where such change requires a massive shift in a fundamental American policy.

INTRODUCTION

A major debate has begun over the geographic constraints which have been a primary factor in shaping the diverse American banking system. The debate is taking place in a rapidly changing competitive environment, in a period of adverse economic conditions and at a time when some of the nation's largest banks are attempting to achieve unprecedented expansion in size, geographic coverage and scope of activities.

The debate centers around the McFadden Act and the Douglas Amendment to the Bank Holding Company Act. These two federal laws give the various states the major role in determining banking structure. They have been instrumental in preventing banks from crossing state lines without the consent of the host state in two key respects: first, the establishment of physical facilities for general banking purposes; and second, in the taking of retail deposits.

The McFadden Act and the Douglas Amendment are part of a longstanding national policy aimed at preventing concentration of banking power and of control and ownership of financial resources. The American banking system disperses the ownership and control of financial resources throughout society much more thoroughly than in any other major industrial country. The result is a diverse mix of large, medium and small banks each serving in its unique way.

The Conference of State Bank Supervisors believes that any proposals to change the existing system must be considered in the context of this broad and longstanding national policy.

The diverse American system--and its underlying constraints against undue concentration of political and financial power--has served the American public and the American economy well. There is no evidence that it is not doing so now, or that it will not continue to do so in the future.

In their efforts to remove limitations on their own expansion, banks favoring consolidation of financial resources have advanced many arguments, foremost among them the contention that the commercial banking industry is losing "share of market." However, periodic change in market share has been primarily the result of interest rate regulation and has had little to do with geographic constraints.[1]

Another contention that the American public will be better served by federally mandated interstate bank ownership ignores the fact that, at present, the American public has access to extensive interstate banking services for which there is a demonstrated need. An individual or business in one state may bank in another state and many do. A bank customer has easy access to his funds deposited in banks in other states through checks, credit cards, debit cards and electronic transfers. Money flows throughout the nation wherever needed to serve the credit needs of individuals and businesses alike through correspondent networks, direct corporate financing, and the federal funds markets.

Moreover, large commercial banks, through various corporate devices, legally reach across state boundaries to provide needed bank-like services. The extent of these services, which include nationwide networks of consumer finance, mortgage banking and other bank-like operations, becomes clearer when the interstate activities of the ten top bank holding companies in the U.S. are reviewed. The results are revealing:

- Bank of America, 375 offices in 40 states;
- Citicorp, 444 offices in 39 states;
- Manufacturers Hanover, 478 offices in 30 states;
- Chemical, 141 offices in 23 states;

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[1] The results of a CSBS study entitled "A Preliminary Inquiry Into The Relationship Between Interest Rate Differentials, Percent of Total Offices and Commercial Bank Share of Deposits Held in Financial Institutions," released October, 1980, support this conclusion. Copies of the study are available from the Conference of State Bank Supervisors.

- Chase Manhattan, 22 offices in 15 states;
- First Interstate, 549 offices in 13 states;
- Continental Illinois, 35 offices in 13 states;
- First of Chicago, 27 offices in 10 states;
- Bankers Trust, 7 offices in 4 states;
- J. P. Morgan, 6 offices in 4 states.

The truth of the matter is that interstate banking services are readily available to most bank customers. Attempts to modify or repeal McFadden and Douglas are for purposes other than to improve interstate services. The primary goal is for banks in one state to gain more deposits from other states. However, national policy has long favored the right of citizens to control their financial resources as close to home as possible, if they so choose, and has opposed the concentration of the ownership and control of the nation's banking resources in the hands of a few. It is this positive national policy which is under attack, and it is this national policy which should be the focus of the debate.

The primary issues, then, are threefold:

1. Control and allocation of individual and community financial resources.
2. Concentration of control and ownership of financial resources.
3. Concentration of government control over the banking structure.

In this paper these issues are addressed under three headings:

I. American Policies on Concentration
II. The American Banking System--A Framework
III. Arguments For Change

SECTION I: AMERICAN POLICIES ON CONCENTRATION

Fundamental to the American banking system is a national policy which strives to limit the concentration of power over the nation's financial resources. While the basic principles upon which this country has been built stand in opposition to concentration, undue concentration of the financial resources of this nation could have unparalleled implications for money and its use. Money is the accepted medium of exchange for all other services. In its control of money, the financial services community has power which no other service sector possesses. It is not surprising then, that over a 200 year period, the American political system has carefully and deliberately developed a series of measures that prevents the undue concentration of power over financial resources.

Economic considerations are a part of the recurring debate over the American banking structure. Nevertheless, the Congress always has decided the final shape of that structure on political and philosophical grounds. The veto by Andrew Jackson in 1829 of the extension of the charter of the Second Bank of the United States, the enactment of the National Banking Act in 1863 creating the dual banking system, and those provisions of the Federal Reserve System Act of 1913 which created a series of regional reserve banks rather than a single central bank were political and philosophical decisions designed to limit the concentration of power over financial resources.

So too were the developments of 1933--modification of the McFadden Act to allow national banks to establish branches to the same extent permitted state institutions and passage of the Federal Deposit Insurance Act to insure the continued survival of thousands of both small and large banks. The former continued the policy of competitive equality based on state laws fashioned by the McFadden Act of 1927.

And finally, passage of the Bank Holding Company Act of 1956 was consistent with the previous philosophical decisions of the Congress to preserve a decentralized banking system and allow individual states to determine bank structure. Congress accomplished this by permitting holding companies only when the state itself authorized the holding company structure and by enacting the Douglas Amendment which restricted bank holding companies to ownership of banks in a single state unless specifically authorized by state statutes.

In 1970, extension of holding company controls to one-bank holding companies was designed, as one observer said, "to prevent the formation of powerful economic concentrations, which, it was feared, might become 'American Zaibatsu'."[2]

It has been implied by some that the states are blocking a rational national policy. This is simply not true; every decision affecting limits on concentration has been made at the national level and this time around will be no exception. National policy sets and always has set the parameters.

Aggregate Concentration and Structural Diversity: Broad Considerations

One may define aggregate concentration as the proportion of assets or output accounted for by the largest firms within the entire economy or some major segment of it. Aggregate concentration differs from market concentration--the share of the largest firms competing in a particular economic market. While U.S. public policy has sought to limit market concentration, its overriding concern has been to limit the aggregate concentration of financial resources.

Aggregate concentration is considered an important indicator of political and economic power.[3] While empirical support for this contention is less than complete, it cannot be dismissed. In the extreme, the contention is clearly correct. In addition, increases in aggregate concentration are largely irreversible so that negative consequences would be difficult to alter.

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[2] Edward Lane-Reticker, in an address before the Conference of State Bank Supervisors, April 1980.

[3] An early concern was expressed by A.A. Berle and G.C. Means, The Modern Corporation and Private Property (MacMillan & Co., New York, 1932). For a more recent analysis, see F.M. Schere, Industrial Market Structure and Economic Performance (Rand McNally Publishing Company, Chicago, 1979), pp. 45-56.

Congress and the courts periodically have expressed concern about concentration of power and wealth in the hands of a few. Similarly, they have endorsed the desirability of retaining a diverse system that promotes and encourages small as well as medium and large producers, each depending on its own ingenuity to provide widely diverse services. This system produces originality and innovation. Further, decentralization of economic power complements democratic government. Centralization of economic power complements autocratic governmental tendencies.

Recent experience in the U.S. indicates that rising levels of aggregate concentration likely will affect adversely the market process itself. Failure of individual firms is part of the market allocation process that distributes resources among competitors and makes the economy more efficient; it is an essential part of the free enterprise system. In recent years, however, the federal government has perceived failure of large firms as excessively disruptive and politically unacceptable. The rescue of Lockheed, Chrysler and First Pennsylvania illustrate this perception. Government policies that prevent dissolutions of large firms resulting from failures in the market place tend to undermine a market system that rewards efficiency.

Aggregate concentration will yield larger firms that seem more important to the economy. Such concentration would increase the number of firms that the government will not permit to fail, thus inviting greater government control of the private sector resulting in less rather than more competition. Those firms protected against failure would have an added important competitive advantage over those firms that are not.

Aggregate Concentration, Structural Diversity, and Competition

In addition to the broad considerations discussed above, it is necessary to consider the possible economic effects of increased aggregate concentration and diminished structural diversity on competition; i.e., on bank market structure and behavior. Recent studies generally have found that multiple-office bank expansion at the state level results in falling numbers of banks, increased size of large banking organizations, and rising concentration.[4]

When the largest organizations acquire important local banks in order to enter new areas, such geographic expansion permits an increasing number of geographic market contacts among relatively few large banking organizations. Some economists consider this type of industry structure, which they term a "linked oligopoly," detrimental to competition. They argue that recognized mutual interdependence in many markets will result in mutual restraint by large firms in each market as such firms become aware that any attempt to benefit fully in markets in which they have advantages would provoke retaliation in markets in which they do not.[5]

In commercial banking, one can conceive of tacit agreements among large aggressive banking organizations.[6] Within this general framework, market-extension acquisitions of strong local banks by large multi-market banking organizations could result in a banking structure that meets the conditions of the "linked oligopoly-mutual forebearance" hypothesis.[7]

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[4] See, for example, Bernard Shull, "The Structural Impact of Multiple Office Banking in New York and Virginia," The Antitrust Bulletin (Fall 1978) and Stephen Rhoades, "Geographic Expansion of Banks and Changes in Banking Structure," Staff Study, No. 102, Board of Governors of the Federal Reserve System (March 1979).

[5] Corwin Edwards, "Conglomerate Bigness as a Source of Power," Business Concentration and Price Policy (Princeton University Press, Princeton, N.J., 1955), p. 35. See also Alexander Henderson, "The Theory of Duopoly," Quarterly Journal of Economics (1954), pp. 565-584 and Almarin Phillips, "A Theory of Interfirm Organization," Quarterly Journal of Economics (November 1960), pp. 602-613.

[6] See Almarin Phillips, "Competition, Confusion and Commercial Banking," Journal of Finance (March 1964), p. 39.

Evidence supports this hypothesis. It appears that a growing number of separate geographic market contacts among large banking organizations diminishes the intensity of bank rivalry.[8]

Recent occurrences in the market place provide insight into the almost certain means of interstate expansion by large commercial banks and lend further credence to the "linked oligopoly" hypothesis. Citicorp's capital infusion through preferred stock--convertible into common stock if legal restrictions that currently prevent such an action are removed--into the $650 million Central National Bank, the seventh largest in Chicago, Chase Manhattan's similar arrangement with the $2.8 billion Equibank, N.A., the third largest commercial bank in Pittsburgh, as well as the more recent arrangement by Marine Midland with the $1.7 billion Industrial Valley Bank, the sixth largest commercial bank in Philadelphia, indicate clearly the approach that will be used by the largest banks.[9]

Just as the largest banks in a state have acquired key banks in local markets within the state, it seems clear that the largest banks in the nation will seek interstate market extension acquisitions involving large institutions in what they view as "local markets." The fact that such institutions are located in the largest population centers within the states, are well-placed to expand within their areas of operation, and that the market value of their stock is substantially below book value are additional incentives. Such a scenario would not add to competition in such markets but would increase substantially the aggregate concentration of the commercial banking industry resulting in the banking structure necessary for the "linked oligopoly" hypothesis to come into play.

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[7] Elinor H. Solomon, "Bank Merger Policy and Problems: A Linkage Theory of Oligopoly," Journal of Money, Credit and Banking (August 1970), pp. 323-336.

[8] Arnold A. Heggestad and Stephen A. Rhoades, "The Influence of Multi-Market Links on Local Market Competition," Review of Economics and Statistics (November 1978).

[9] The Federal Reserve Board has recognized this problem and has released a policy statement regarding this situation.

There has been considerable discussion over the years of the willingness and ability of large multi-market firms to drive small local rivals out of business, into mergers, or into tacit agreements unfavorable to the growth and development of the smaller firms. Historically, local independent banks have expressed fear and antagonism toward increasing market contacts with larger organizations. The "linked oligopoly" hypothesis implies that a different relationship would exist among large multi-market organizations than the one between such large organizations and small local firms.

> The small concern's business is limited geographically, or in the communities it covers, or in the classes of customers with which it is concerned, or in some other way, and the large company can seldom be seriously injured by aggressive tactics which the small one may undertake, or by retaliatory or disciplinary tactics which may be employed against it by the small company.[10]

Applying the concept to commercial banking acquisitions:

> The theory may also be relevant to the analysis of a series of acquisitions, by leaders, which increases--usually within numbers of closely related markets--their market power and ability to dominate the remaining members of the group, especially when the mavericks or potential rivals are

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[10] Edwards, pp. 335-336.

> at the same time eliminated within the same network of markets.[11]

Finally, two recent studies conclude that the elimination of geographic barriers to interstate bank ownership would not result in more competitive local structures and that it would increase the concentration of U.S. banking resources.

> The findings of this study do not indicate that geographic expansion by banking organizations results in more competitive local market structures. Thus, it is not clear that liberalization of state branching laws or, at a greater extreme, nationwide branch banking generally can be depended on to bring about more competitive local market structures. The evidence does suggest that liberalization of branching laws will generally result in an increase in statewide banking concentration and it seems reasonable to suspect that nationwide branching would have a similar effect on nationwide banking concentration.[12]
>
> Economic theory generally supports a reduction of barriers to entry of any kind (for example, quotas and tariffs) because that reduction should foster more competitive market structure and performance. However, some evidence based on the experience of individual states with widely varying laws on bank entry and branching suggests that lowered barriers to entry for banks have an adverse effect on both local-market and state structure. This result probably is attributable not to lower barriers per se, but rather to policy in connection with market-extension mergers. Thus under existing merger laws a reduction in restrictions on interstate banking is unlikely to have a favorable effect on

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[11] Solomon, pp. 327-328. See also Paul M. Horvitz and Bernard Shull, "Branch Banking, Independent Banks and Geographic Price Discrimination," The Antitrust Bulletin (Winter, 1969); Bernard Shull, "Bank Expansion: The New Competition and the Old Predatory Practices," The Banking Law Journal (September 1974).

[12] Rhoades, "Geographic Expansion of Banks and Changes in Banking Structure," p. 20.

> local-market banking structures, and it is almost certain to increase the concentration of U.S. banking resources.[13]

Effectiveness of American Policies on Concentration

Is this U.S. national policy against concentration of financial resources effective? In general it is, although in recent years there have been some increases in concentration.

There is strong evidence that suggests that aggregate concentration in the banking industry is well below that in other industries. The nation's ten largest banks hold only 27.8 percent of the country's commercial bank deposits, and the top 100 only 50.9 percent. The figure for the ten largest banks has increased in recent years, clearly demonstrating a trend toward increased concentration of the commercial banking industry (see Table 1).

One sees a markedly different picture when examining such figures for other industries. The top ten companies in the life insurance industry hold 52.5 percent of all assets, and the top 50 hold 77.4 percent (see Table 2).

Many non-financial industries show tremendous concentration within a limited number of companies. Examining statistics for only four companies within certain industries offers some startling share of market figures: cigarettes 84 percent, coffee 65 percent, alkalies and chlorine 72 percent, metal cans 66 percent, and passenger cars 99 percent (see Table 3).

One must recognize, moreover, that where concentration of banking resources has occurred, it largely has been a local decision, fitting the perceived circumstances in the individual states and recognizing the diverse needs of their economies. And even this appearance of concentration is deceptive. If we speak not of the commercial banking business, but of the financial

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[13] Stephen A. Rhoades, "The Competitive Effects of Interstate Banking," Federal Reserve Bulletin (January 1980).

Table 1

COMMERCIAL BANK CONCENTRATION
(December 31 figures)

Percent of all Commercial Bank Deposits Held by the Largest Banks

Number of Banks	1981	1970	1960	1950	1940	1930
10	27.8	26.0	21.3	19.9	29.4	19.5
25	[illegible]7.5	36.3	30.9	29.8	43.5	--
50	43.9	44.1	38.5	37.4	52.4	--
100	50.9	52.7	47.3	45.9	62.4	43.7
200	58.3	61.9	56.4	54.6	71.0	--
300	62.5	66.8	61.5	59.6	75.7	--
400	65.3	70.4	65.0	63.0	78.7	--
500	67.8	73.0	67.5	65.6	81.0	--
1,000	74.1	80.1	75.1	73.3	87.8	--
All others	25.9	19.9	24.9	26.7	12.2	--

Sources: American Banker, FDIC Annual Report, Federal Reserve Bulletin. "Commercial Bank Deposits" includes both foreign and domestic deposits.

Table 2

PERCENTAGE OF TOTAL LIFE INSURANCE COMPANY ASSETS HELD BY TOP n LIFE INSURANCE COMPANIES

	Year				
n	1980	1975	1970	1965	1960
10	52.5	55.3	57.7	59.8	67.4
50	77.4	80.3	82.9	85.5	87.8
All others	22.6	19.7	17.1	14.5	12.2

Source: Statistical Abstract of the U.S., 1981.

Table 3

PERCENT OF VALUE OF SHIPMENTS ACCOUNTED FOR BY THE FOUR LARGEST DOMESTIC COMPANIES, BY YEAR

	Year					
Industry/Product Class	1972	1967	1963	1958	1954	1947
Cigarettes	84	81	80	79	82	90
Roasted Coffee	65	53	52	NA	NA	NA
Envelopes	31	32	32	30	27	30
Book Printing	24	21	19	24	21	NA
Alkalies and Chlorine	72	63	62	64	69	70
Petroleum Refining	31	33	34	32	33	37
Metal Cans	66	73	74	80	80	78
Prepared Photographic Chemicals	80	84	80	71	73	NA
Ship Building and Repairing	46	42	48	48	43	NA
Aircraft	69	76	58	62	55	NA
Passenger Cars	99	99	99	99	99	NA

NA=Not Available
Note: At the time this table was prepared, figures for 1977 were not available. Data are published approximately every five years.
Source: Department of Commerce, Census of Manufacturers.

intermediary business, the growth of thrift institutions and credit unions suggests that concentration in terms of alternatives within the marketplace may actually have decreased over time.

Safeguards Against Undue Concentration

There are three primary safeguards in our national policy against undue concentration in the commercial banking industry. In order of importance, they are:

1. The McFadden Act as amended in 1933 and the Douglas Amendment to the Bank Holding Company Act of 1956.
2. The antitrust laws, which apply equally to banking as they apply to other industries.
3. The dual banking system, the final layer of defense that assures local control against such concentration.

Those bankers that seek to remove McFadden and Douglas limitations on their own expansion acknowledge the harmful effects of an overly concentrated commercial banking industry; but they argue that the antitrust laws, the policies of governmental agencies, and to a lesser extent the dual banking system will prevent increases in concentration from reaching dangerous levels. Such an argument reflects a lack of understanding about the historical development of commercial banking and ignores data that illustrate the ineffectiveness of the antitrust laws in preventing undue concentration in other industries.

The United States has the most diversified, decentralized banking system in the world. But the antitrust laws did not bring this about. While enacted almost a century ago, antitrust laws were not applied to banking until 1960.[14] It was a series of Congressional actions--principally the McFadden Act and its amendments and the Douglas Amendment--that has produced our diversified, decentralized banking system.

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[14] The Bank Merger Act was enacted in 1960 and substantially amended in 1966. The Supreme Court held that Section 7 of the Clayton Act was applicable to banks in United States v. Philadelphia National Bank, 374 U.S. 321 (1963).

The antitrust laws always have applied to most other industries. And yet, how many cigarette companies do we have? Life insurance companies? Automobile companies? Tables 2 and 3 provide the answers; not very many for these and other industries. In most of the industries listed in Table 3, three to eight companies dominate the markets. None of these industries approximates the 14,000 independent units that exist in commercial banking. The evidence demonstrates that the antitrust laws have not been as effective in preventing undue concentration in American industry as the McFadden Act and Douglas Amendment have been in the banking industry.

While antitrust and banking laws severely limit acquisitions, the Justice Department has been notably unsuccessful in preventing them. It has lost every commercial banking suit initiated under the potential competition doctrine. And the three federal bank regulatory agencies have differed considerably in their views toward certain acquisitions. Even the agency most concerned with potentially adverse effects--the Federal Reserve Board--has exhibited an uncertain policy.

As noted earlier, elimination of McFadden and Douglas restrictions would result in numerous market extension acquisition proposals. Experiences with antitrust laws in other industries and the lack of success in applying the potential competition doctrine within commercial banking demonstrate that current antitrust laws will not restrain the inclination for increased aggregate concentration and thus will not prevent the loss of diversity and the long-run anticompetitive effects resulting therefrom. Much more than the antitrust laws, the McFadden Act and the Douglas Amendment have prevented concentration in commercial banking.

The dual banking system has been a critical element in American policy to prevent concentration. Local control and local chartering authority implicit in the state system serving beside the national bank system have created a diverse structure. While the dual banking system remains a key safeguard of the decentralized structure, it does so only because McFadden and Douglas give the states a primary role in determining bank structure.

Summary

The United States has developed a national policy designed to limit concentration of power over the nation's financial resources. The Congress continually has upheld this policy through the enactment of major banking legislation. Today, the cornerstones of this policy are the McFadden Act as amended in 1933 and the Douglas Amendment to the Bank Holding Company Act of 1956. These two federal laws, not the antitrust laws, assure the effectiveness of American policy against undue concentration of financial resources.

The debate over proposed changes in the geographic constraints that shape the American banking system must take place within the framework of this longstanding national policy. Any changes in the system should conform to this national policy, or the Congress should consciously change the policy itself.

To this end, the Conference of State Bank Supervisors believes that the fundamental policy question involved in a review of McFadden and Douglas is the following:

> Should the longstanding American policy of constraints designed to prevent undue concentration of financial resources be continued?

Those who would reverse the present national policy bear the burden of proof. It is they who must show that increased concentration of financial resources is desirable from a public policy standpoint.

SECTION II: THE AMERICAN BANKING SYSTEM--A FRAMEWORK

The American banking system is diverse and multiplex; no rule governs exclusively. For example, while interstate contraints exist, they do not prohibit the conduct of interstate bank services. Both institutions and regulations are--as a matter of history and policy--diverse. Moreover, rapidly advancing technologies are enriching this complex system.

The interrelationship between the development of a nation's economy and its banking system is obvious. It is not coincidental that the United States, which has a decentralized banking system that fosters creativity and innovation, has the most innovative and powerful economy in the world.

There are several key aspects of the American banking system that contribute to its overall effectiveness: local control, diversity, duality, and a national focus. Each of these is discussed herein, and when appropriate, contrasted with the banking systems that exist in major foreign countries. Also, this section addresses the potential effect of new technology on the banking system.

Local Control

One major feature of the American system is the amount of control over the system exercised at local levels.

The courts have recognized the extent to which banking is a local concern and the Congress has supported the dual regulation of banking.

> . . .We readily accept the submission that, both as a matter of history and as a matter of present commercial reality, banking and related activities are of profound local concern...sound financial institutions and honest financial practices are essential to the health of any State's economy and to the well-being of its people. Thus, it is not surprising that ever since the early days of our Republic, the states have chartered banks and have regulated

> their activities.[15]

> Whatever may be the history of federal-state relations in other fields, regulation of banking has been one of dual control since the passage of the National Bank Act in 1863.... And unquestionably, as in other businesses, federal presence in the banking field has grown in recent times. But Congressional support remains for dual regulation. In only a few instances has Congress explicitly preempted state regulation of national banks. More commonly, it has been left to the courts to delineate the proper boundaries of federal and state supervision.[16]

This system is in stark contrast to most foreign banking systems and is itself the product of deliberate American decisions at all levels applied uniformly throughout our national history.

1. Local ownership of financial institutions.
2. Local control largely through barriers to massive national institutions.
3. Local political authority over the chartering and operation of financial institutions--largely exercised today through the dual banking system of side-by-side state and national regulatory systems (the latter in many carefully delineated areas linked to state laws).

This tripartite effort--local ownership, determination of structure, and regulation--has insured that the influence financial institutions exercise over the monetary activities of American businesses and individuals will be controlled essentially within the territories served. This is the essence of local control.

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[15] Opinion of the Supreme Court, October Term-1979, Lewis, Comptroller of Florida v. BT Investment Managers, Inc., et al.; Appeal from the United States District Court for the Northern District of Florida, No. 79-45, Argued January 15, 1980-Decided June 9, 1980, page 38.

[16] National State Bank v. Long, 630 F. 2nd 981, 985 (3rd Cir. 1980).

Moreover, local control helps insulate this system from greater political domination without inhibiting the flow of money both locally and nationally in response to explicit needs. In foreign countries, the relative importance of large banking organizations is not indicated fully by their market shares which themselves are substantially higher than comparable U.S. concentration levels (see Table 4). In many foreign nations, relationships exist between the government and the large banks that are intimate, complex, and ultimately dominated by the government sector.

These close relationships reflect the crucial importance of commercial banking to economic stability and growth. Where banking resources are highly concentrated in the hands of a few, they become a greater focal point for public policy. A continual process of mutual accommodation occurs between the government and the large banks.

Canada offers an excellent example. The supervisory structure as such is quite limited; there are, after all, only 11 chartered banks. But the moral suasion and the close interlocks between government and policy on the one hand and the small number of bank executives on the other is a constant and subtle process.

Diversity

A central facet of the American financial system has been the development of diverse institutions--some institutions whose powers are very broad, some which concentrate on narrow segments of their local markets, some whose operations span the earth and some which serve a single trade area. Aggregate concentration traditionally has been low and structural diversity has been high. This diversity exists in three critical dimensions: size, scope of service and structure.

Table 4

NUMBERS OF COMMERCIAL BANKS AND CONCENTRATION IN SIX SELECTED COUNTRIES

	Number of banks	Per cent of deposits held by three largest banks
Canada	11	47
Federal Republic of West Germany	243	42
France	296	43
Great Britain	13	47
Japan	83	22
United States	14,375	15

Sources: Data are from several sources and not strictly comparable. Differences among financial institutions in foreign countries, moreover, make "commercial banking" comparisons difficult. However, the above information is believed to represent a reasonably accurate comparison of banking structures in the countries indicated.

Units of all sizes comprise the American financial system; in commercial banking they range from over $100 billion down to a few million in assets. The largest banking organizations are approximately 1,000 times as large as the banks of average size. This great disparity in size contributes to the variety of services offered by different types of commercial banks. Some offer one or two highly specialized services while others offer the entire gamut of financial services. Commercial banks, mutual savings banks, mutual and stock savings and loan associations, and credit unions all are to be found in the ranks of financial intermediaries--and increasingly non-regulated (in a banking sense) competition is entering these fields. These institutions offer a great variety of services, although the product differentiation that was so much a feature of the financial intermediary as recently as ten years ago has begun to decline as Congress has enacted legislation eliminating mandated differentiation.

Because of this multiplicity of service organizations and the American insistence on local controls, there are far more options in the marketplace than exist in most, if not all, nations. There are approximately 14,000 commercial banks, 3,800 savings and loan associations, 500 mutual savings banks, and 22,000 credit unions--a total of 40,300 financial intermediaries.

Bank Structures In Selected Foreign Countries

The most striking contrast between banking structure in the United States and that in foreign countries is in the number of banking organizations. The numbers of comparable commercial banking organizations in the group of five foreign countries examined range from 11 in Canada to under 300 in France and West Germany (see Table 4).

Consistent with the smaller numbers of organizations, aggregate concentration is considerably higher. Concentration ratios range from 22 to 47 percent for the three largest banks.

In Canada, the five largest hold 90 percent of total deposits held in commercial banks.

The significance of high aggregate concentration in these countries has not been explored fully. However, one recent study has shown that profitability of the larger banking organizations is directly related to the level of nationwide aggregate concentration.[17] In the United States, in contrast, it is generally thought that bank pricing and profitability are related to concentration and competition in the local and possibly statewide areas in which banks have offices and not to aggregate concentration at the national level.

One possible explanation for this finding in foreign countries is that the concentration of banking organizations on a national level has expanded geographic markets so that credit and deposit markets for even small businesses and consumers are nationwide.

Duality

A major facet of the American banking system is duality--the existence of a state-chartered and supervised system and a nationally-chartered and supervised system. Perhaps the key to the success of the dual banking system has been its ability to foster competitive innovation. One system or another will develop new competitive approaches which, if proven useful, will be accepted universally. The various state systems usually have served as laboratories for change; occasionally, the federal system has so served. Noted state initiatives include checking accounts, the NOW account, shared EFT networks, deposit insurance, holding company legislation, trust powers, and mini and top down bank examinations; but one could cite others. The critical element has been a creative tension between the two systems which leads to innovation and its diffusion.

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[17] Brock H. Short, "The Relation Between Commercial Bank Profit Rates and Banking Concentration in Canada, Western Europe, and Japan," Journal of Banking and Finance, (1979).

This is noticeable in legislative and regulatory activities. Without the creative tensions inherent in duality, government and the banking industry would tend to stress the known, the accepted, and the proven aspects of a system. Because of duality, however, a stagnant system is not permitted to exist for very long. This is a major element of the American system, and the primary reason for its success.

National Focus

A notable feature of the American system is its broad national applicability. Despite arguments that it is "state-bound," nothing could be further from the truth. With respect to most facets of banking--corporate and retail alike--a financial institution with the resources and the commitment can offer its services nationally.

On the corporate side, there is an expansion of nationwide lending, deposit-taking, data processing and other services through broad networks of loan production offices, calling officers, lockbox systems and specialized holding company affiliates.

On the retail side, many services are offered across state lines. Holding company subsidiaries offer consumer and retail mortgage credit services; many major banks have developed credit card portfolios where from 10 to 30 percent of their cards are held outside the home bank's state base and interstate debit card cash retrieval systems are well on their way.

Data on the extent of interstate expansion by large bank holding companies are not readily available; but there is enough information available to indicate that it has been substantial. As set forth in the Introduction of this study, 10 large bank holding companies have non-bank subsidiaries with 2,084 offices located outside the state in which the lead bank of the holding company is headquartered. These 10 holding companies have some type of non-banking operation in at least 40 states. The largest numbers of offices are in the finance company area, with mortgage banking running second. In 1976, bank holding companies controlled 35 of the largest 100 non-captive finance companies providing such services as consumer financing, sales financing, factoring, and full payment leasing. Bank holding companies also controlled 47 of the 100 largest mortgage banking companies.[18]

The ease with which funds flow through the system is augmented by three major elements of the financial network. One is the correspondent banking system where funds readily flow up and down the banking ladder and through which the most sophisticated services are provided. A second element is the easy access banks and other financial intermediaries have to national secondary markets such as those serving the residential mortgage and student loan markets. Finally, there is the federal funds market, through which banks of all sizes buy and sell funds on a short-term basis.

This system allows local institutions to exercise a favorable degree of control over the allocation of financial resources from each area. Each bank determines daily whether to buy or sell funds, thus insuring that individuals and communities of individuals have a voice in the allocation of their financial resources and that funds are available when local needs dictate. Conversely, when local needs are not strong, capital flows in response to needs of nationwide money market centers.

Using all these tools, banking is indeed national in scope. The only element of banking which is heavily restricted is retail deposit-taking authority which is largely controlled by geographic disciplines. Even here, states have moved to relax this restriction, especially in the New England area, and interstate gathering of retail deposits by mail remains a common occurrence.

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[18] Data on this subject can be found in a series of articles in The American Banker in the Fall and Winter of 1975. Also see Raoul D. Edwards, "The Interstate Banking Issue Heats Up," United States Banker, October 1981.

The main point of this paper must be stressed again. Geographic barriers contained in such legislation as McFadden and Douglas are not designed to prevent interstate activity. They are designed to prevent massive concentration of financial power, to limit concentration of corporate ownership and control of banks and to insure local control over the allocation of financial resources.

SECTION III: THE ARGUMENTS FOR CHANGE

The arguments advanced by the proponents of full interstate bank ownership by federal preemption and centralized control encompass the issues of nonbank competitors, loss of market share to thrift institutions, advantages of foreign banks, capability to provide service, and advanced technology. These arguments are advanced as major justification for centralized control and resource concentration. These fundamental issues and the questions they bring to mind should be studied with great care.

Before examining these issues, it is necessary to focus briefly on the term "interstate banking." Different individuals or groups interpret this term in widely divergent ways. Some use interstate banking to mean providing banking services across state lines. Others contend that interstate banking refers to the establishment of facilities or branches across state lines for the purpose of gathering deposits. Still others interpret interstate banking to be the ownership of banks by bank holding companies in more than one state. But, the question of who should determine the nature of interstate bank ownership, the federal government or each state, is of paramount importance regardless of how one defines interstate banking.

These distinctions are important. The proponents of change tend to gloss over them. They erroneously imply that the only way to obtain interstate services is to dilute or destroy McFadden and/or Douglas and thus end the longstanding policy of state determination of bank structure.

The "Market Share" Issue--Nonbank Competition

It is indisputable that the commercial banking business has lost share of market to other financial intermediaries in the past 40 years. The emergence of nonbank competitors also has cost the American banking system a substantial share of the market to organizations not bound by constraints imposed on traditional depository institutions. Moreover, the trend has been accelerating over the past five years.

This problem developed most dramatically with the acceleration of money market mutual funds (MMMFs) in 1979. Assets in these funds rose from $11 billion to over $200 billion in less than four years. MMMFs in effect accept retail deposits often linked to a credit card.

Other types of non-traditional depository institutions, e.g., Beneficial Finance, Sears and industrial banks, are empowered to offer consumer loans, first and second mortgages, and credit cards, to gather deposits and to issue short-term small denomination notes to consumers which is, in effect, a method of tapping the retail deposit market.

Proponents of accelerated interstate bank ownership by federal preemption argue that commercial banks must be allowed to match the powers of these nonbank institutions if commercial banking is to continue to serve the nation and that a vital competitive advantage of nonbank competitors is their ability to establish a national scope of operations. It is argued that commercial banks must be allowed to expand nationwide irrespective of state needs or desires in order to compete with these nonbank entities.

Federal arrogation of state determinations of bank ownership patterns, however, would not significantly alleviate the market share problem. Nonbank competitors such as the money market mutual funds secured funds through interest rate advantages and not because of their ability to operate over a broad geographic area.[19] A modification of the Douglas Amendment or elimination of the McFadden Act provisions so as to permit geographic expansion and retail deposit-taking would only influence individual bank's ability to expand within the limited share of market already held by the banking industry. In other words, efforts to fracture McFadden/Douglas are motivated by an intention to consolidate existing banking resources into fewer hands not to obtain a greater share of the total pool of financial resources for the banking industry as a whole.

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[19] As of December 1, 1982, assets in MMMFs were $232.6 billion. By March 2, 1983, which was approximately two and one-half months after the effective date (December 14, 1982) of commercial banks' new limited high yield money market accounts, MMMFs assets fell to $189.4 billion. With the competitive advantage of nonbank institutions significantly diluted, commercial banks now are able to compete effectively for an increase in funds and thus, a greater share of market.

Recent relaxation of interest ceilings has provided the opportunity for traditional depository institutions to compete on a more equal basis with nonbank competitors and the elimination of other regulatory disparities between banks and nonbank competitors would further strengthen banking's competitive position. The reality of the situation clearly indicates that the proponents of accelerated interstate bank ownership by federal preemption have a solution that does not fit the problem.

The "Market Share" Issue--Thrift Industry Competition

History provides ample data to prove the point made above. One of the more dramatic trends of the past 30 years has been the growth of savings and loan associations and a corresponding loss of market share by the commercial banking industry. The savings and loan industry moved from around $7 billion in assets in 1945 to $700 billion today. In like manner, credit unions grew from a miniscule amount to $85 billion over a shorter time span.

Federally chartered savings and loans are not subject to the McFadden Act and the Federal Home Loan Bank Board has authorized them to branch over broader geographic areas than many states allow commercial banks. The proponents of accelerated interstate bank ownership by federal preemption argue that commercial banking is losing market share of all financial intermediary deposits because of its inability to expand geographically to the same extent as thrift institutions. This claim has as little merit in the case of the thrift industry competition as it has in the case of nonbank competition.

From 1945-1978 commercial banks largely maintained their market share of total time and savings deposits held in traditional depository institutions. When their share of total deposits declined, this largely was due to two factors: (1) the public shift away from noninterest-bearing demand deposits, a service provided solely by commercial banks, to time and savings deposits, a service which historically banks have shared almost equally with S&Ls; and (2) differences in interest rates paid by commercial banks and competing institutions.[20]

Analysis of market share data indicates there is a strong correlation between interest rates paid by competing institutions and shifts in market share of time and savings deposits. Little or no correlation, however, has been found between changes in the total number of offices of the competing banks vis-a-vis S&Ls and shifts in industry market shares.[21] Interest rate disparities not geographic limitations have been the operative cause.

From the findings presented above, one must conclude that accelerated interstate bank ownership by federal preemption will not solve or even address the commercial banking industry's market share problem.

The Canadian experience provides additional support for this conclusion. Canadian banks have had nationwide branching authority for many decades. At no time has Canada had over 30 banks in operation. There have only been 163 Canadian bank charters issued in its history and only 102 of these were exercised at one time or another. There are only 11 domestic Canadian chartered banks today and five of them possess full nationwide branch networks.

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[20] See "A Preliminary Inquiry Into the Relationship Between Interest Rate Differentials, Percent of Total Offices and Commercial Bank Share of Deposits Held in Financial Institutions," a study by the Conference of State Bank Supervisors, October 1980.

[21] Ibid.

Nevertheless, Canadian banks have been losing share of market to other nonbank financial intermediaries, most notably trust companies, which in Canada function much like savings and loan associations but with trust authority not available to banks. Credit unions also are growing far faster than the chartered banks, in absolute terms, for many of the same reasons they are growing in the United States. In Canada, it is not a matter of goegraphic reach but of different powers. The same is true in American markets.

"Advantages" of Foreign Banks

Additional pressure is said to be placed on domestic commercial banks from foreign bank activities in the United States and from foreign interests buying American banks. While a complete analysis does not exist, preliminary studies by the Office of the Comptroller of the Currency suggest that the advantages believed to be possessed by foreign banks may not be as significant as supposed; they are not strong earners compared to American banks and they are far more active in wholesale than in retail markets.

It is asserted that foreign bank competitive advantages include greater freedom to operate on an interstate basis, particularly through "grandfathered" operations; lower rates on credit due to different reserves or capital constraints; and exemption from Community Reinvestment Act requirements. It is also pointed out that they track American money center banks in their interest in middle market customers and that foreign-owned banks are active in local retail markets. However, it must be recognized that while these assertions may be true, foreign banks have been encouraged by states to operate on a multi-state basis in order to provide needed services that would not be provided by domestic banks even if they operated interstate facilities.

Until 1978, foreign banks were allowed to open branches in any state which allowed them to do so. Foreign bank holding companies, on the other hand, were subject to Bank Holding Company Act restrictions. The International Banking Act of 1978 (IBA) sought to create equality of treatment between foreign-owned banks and American-owned banks--with the exception of grandfathered institutions. However, one should note that domestic interstate bank holding companies have been grandfathered under the Bank Holding Company Act as well.

Under the IBA, foreign banks must select a home state for full banking activities. They may operate Edge Act Corporations across state lines, but only on the same terms allowed to American bank owned Edge Act companies. Agencies are still permitted in more than one state. In effect, the "advantages" foreign banks once possessed--in a geographic sense--have been negated.

The "Service" Issue

It is argued that accelerated full service interstate bank ownership and control by federal preemption will provide better service to the public. Inherent in this assumption are allegations that the existing system does not serve the public well because of various factors; e.g., inefficient use of capital, diseconomies of small scale, and imbalances in asset versus liability authority. It is also suggested that the public desires a change--a broader outreach by the large institutions.

Two ways to determine if full interstate bank ownership really would serve the public better would be to assess whether or not such a system would provide (1) more competition and (2) additional services to bank customers. In an earlier segment--"Aggregate Concentration, Structural Diversity, and Competition"--it was concluded that increased competition likely would not result from a system of full interstate bank ownership. Even to the most jaundiced of observers, data from the experiences in this country within the states and with foreign banking systems raise serious questions about the promises of a more highly competitive banking system under full interstate bank ownership.

One must preface the question of additional services with a determination of the extent of interstate services within the present system. In Section II, the interstate operations of 10 of the largest bank holding companies were discussed; bank holding company involvement in nonbank subsidiaries activity examined; and the types of services that it is known banks provide interstate listed, although little or no data are available to measure the amount of such services. The available data imply the existence of a magnitude of interstate bank services, but unfortunately do not provide much information regarding number of banks or bank holding companies operating interstate and the extensiveness of such operations by institutions below the very largest.

CSBS commissioned a study, "The Interstate Banking Issue in Perspective," and one of the items examined was the extent of services banks or parent bank holding company subsidiaries currently provide in other states.[22] The percentage of financial organizations above $100 million in total assets providing services in other states was large: $1 billion or more, 87%; $500 million to $1 billion, 64%; and $100 to $500 million, 38%. The banks surveyed identified 20 different services they or their subsidiaries currently provide in other states. The percentage of organizations with over $1 billion in total assets providing some of the specific services cited was also most impressive: loans to corporations, 35%; Edge Act Corporations, 25%; management/financial counseling, 22%; mortgage banking operations, 30%; consumer finance operations, 32%; and deposit collection/ savings, 13%. Further, 95% of all bank CEOs contacted did not or could not identify interstate banking services not now adequately provided and those few who did identify needed services most frequently mentioned deposit-gathering and handling.

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[22] Market Facts--Washington, The Interstate Banking Issue In Perspective, 1981. Copies available from the Conference of State Bank Supervisors, Washington, D.C.

The existing flexible U.S. banking system certainly has allowed banks and bank holding companies to provide a substantial variety and amount of services in other states. From the percentage of banks that have chosen to provide such services and the recognition of the adequacy of interstate services, it is clear that management decision, not legal constraints, is the determining factor.

Given this, one must naturally ask, what services do McFadden and Douglas prevent banks from offering in other states? What is the so-called "service" issue? The answer to the first question is almost none. The "service" issue is clearly an attempt by some banks to mask their real intention--the gathering of retail deposits--because what they propose would not provide additional services to the public. Indeed, there would be little public benefit, since as discussed above, it is unlikely there would be a significant increase in competition.

Additionally, those who seek change charge that the U.S. banking system fosters the inefficient use of capital and that Congress must achieve a "rationalization" of banking resources by allowing pools of capital to support larger pools of deposits and investments or loans. They argue that larger banks are allowed to operate with smaller capital ratios than smaller banks; therefore, folding smaller banks into larger banks will maximize the efficient use of capital.

This is a dangerous argument on two grounds. First, it assumes that local owners do not have the wisdom or even the right to decide how to invest their capital. If they are willing to maintain a higher capital ratio in their own financial institutions, why should this be unacceptable? Second, it accepts the thesis that larger banks may be inherently "safer." The experience of the past 20 years does not support this contention; and as discussed earlier, a large bank/centralized regulatory partnership has begun to develop in which regulators are most reluctant to permit larger institutions to fail. The inevitable result has been and increasingly will be more comprehensive political control over the industry.

"Rationalization" also is cited to suggest that accelerated interstate bank ownership by federal preemption would result in the elimination of inefficient banking units. However, study after study shows that true economies of scale do not tend to operate beyond the $50 million size range, and earnings patterns over many years consistently show that banks in the $25-$100 million range earn more on assets and on capital--even with higher capital ratios--than do larger banks.[23] Further, even though our nation obviously needs some large banks, there is no evidence to suggest that changing the present small-medium-large bank mix to accommodate more large banks would be in the public interest.

It is argued that commercial banks operate under current imbalances between the asset and liability authorities they possess, make loans and investments wherever they choose, but are limited in the ability to attract retail, core deposits. This is a hollow argument since the decision to move outside their deposit gathering areas when making loans is a management decision, not one mandated by law. Any bank that so desires can restrict both sides of the balance sheet to comparable trade areas.

Also, large banks continually tap capital and funds markets far beyond their home state, through large CDs, holding company commercial paper, foreign deposits and corporate deposits. The authority exists--and has been used on occasion--to tap retail deposit markets outside normal trade areas by advertising and bank-by-mail techniques.

Finally, the existing banking system moves funds with great efficiency. When any bank of any size in any trade area holds a surplus of funds, it readily can sell them to other banks in need of funds.

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[23] See Alan S. McCall, "Economies of Scale, Operating Efficiencies and the Organizational Structure of Commercial Banks," The Journal of Bank Research, Summer, 1980.

Some argue that the concentration of regulatory power in Washington mandates a banking structure that will achieve a matching concentration of banking resources. This argument for contraveiling concentrations of power between federal regulatory authorities and the industry misses the point. For the most part, the concentration of regulatory authority in federal agencies has occurred over the last 20 years, without consideration of its full consequences on the regulatory and industry structures. Rather than compound the adverse effects of regulatory centralization by parallel banking resources concentration, both should have a balance of centralization and decentralization.

Only as long as the dual banking system retains its vigor under the aegis of the McFadden Act and the Douglas Amendment, and the states maintain a significant role in chartering and supervisory authority will this nation avoid a stifling centralization of control over its financial structure. The principles of diversity and prevention of undue concentration which still prevail in the banking structure should be applied aggressively by Congress to the bank regulatory structure.

The Technology Issue

The emergence of electronic funds transfer (EFT) services offered by financial institutions to their customers wherever they are and whenever financial services are needed is a harbinger of electronic network banking. The technology exists today for statewide, regional, nationwide and even worldwide financial communication through electronic networks.

In the western part of the United States, a multi-state ATM system is being operated for customers of affiliates of a single bank holding company. In addition, there is a multi-state system operated by an EFT transaction item processing organization and any financial institution in a state served by the processor wishing and able to participate may do so.

Multi-state and regional EFT systems are emerging in the central and eastern parts of the country, but at a much slower rate than in the west. This may be due, in part, to higher population density and more pervasive laws in these sections of the country. Nonetheless, national and regional EFT systems are developing quite rapidly and largely in a manner which allows customers to receive financial services from their own institutions without regard to where the customers are when financial services are needed.

With growing demand for any-place, any-time access to financial services it is relatively easy to forecast the eventual linking of regional and national EFT systems into worldwide financial communication systems.

Moreover, a major thrust is developing to direct EFT toward the home, which would significantly reduce the need for brick-and-mortar expansion, especially for providing financial services. Banking by phone is still a modest service, but is offered with success in several markets. Cable television systems are experimenting with banking access in several areas.

It has been suggested that technological advances mandate change; that a major force for consolidation of banks is

> economies of scale associated with new electronic and other technologies, as well as the provision of more sophisticated services...technology has virtually eliminated time and space barriers as it affects the delivery of all types of financial services. Locational concepts from 'horse and buggy days' are anachronisms in a world of satellite communications. Technology should be viewed as a 'liberating force'--particularly with respect to the deposit-gathering function.[24]

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[24] Frederick Deane, Jr., in an address to the Association of Bank Holding Companies, June 1980.

However, costs associated with technology, development of networks, of mini-computers, of bank cards, etc., all suggest that banks of most any size can gain full access to electronic funds transfer systems.

> The development of technology makes it just as possible to interconnect 35,000 offices of 15,000 banks as it does to interconnect 35,000 offices of ten banks, five banks or one bank. In fact, if anything, the development of this technology serves to reduce in some degree whatever advantages economies of scale may afford larger banks.[25]

Development of EFT networks, national card systems, and shared ATM systems virtually eliminates the necessity for interstate offices to provide financial services--technological developments allow the customer to interface with his financial institution from any part of the nation electronically without the need for brick-and-mortar branches. When banking information--direct deposit services and withdrawals by card or phone--moves as "sparks on a line," geographic limitations to providing financial services through physical offices largely lose their meaning.

CSBS fully supports technological developments including shared ATM and bank card networks, pay by phone systems, and the like, so long as the shape of a system serving the people of a state is determined at the state level. State determination would insure (1) maintenance of the checks and balances in our state/federal system, (2) development of systems that will best meet diverse needs of particular states, and (3) access to systems by all institutions regardless of size. CSBS has encouraged states to enact legislation allowing customers of local financial institutions to obtain financial services when they are away from their institutions and significant progress is being made.

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[25] Edward Lane-Reticker, in an address before the Conference of State Bank Supervisors, April 1980.

Summary

The three major problems advanced by proponents of accelerated interstate bank ownership by federal preemption are market share, services and technology issues. All are important to the banking industry, but none requires the fracturing of McFadden and Douglas as a solution. Canadian and other foreign experiences suggest that even in a nationwide branching environment, if such restriction on activities exists, commercial banks suffer from competitive disadvantages and lose share of market to other financial intermediaries.

Indeed, as we have seen, these concerns mask other more pressing problems including powers granted different financial intermediaries, inequitable restrictions on rates and greater regulatory cost burdens placed on commercial banks as compared to other financial intermediaries. Greater rate flexibility, freedom of powers and regulatory cost "equality" would address the issues raised by most proponents of accelerated interstate bank ownership by federal preemption. These solutions would address the real disadvantages suffered in the marketplace by commercial banks. Accelerated interstate bank ownership by federal preemption, other laws remaining constant, would do little or nothing to alleviate competitive disadvantages of commercial banks.

SECTION IV: CONCLUSIONS

In considering change of geographic structural limitations, Congress must recognize that such limitations reflect a series of major longstanding national policies, and it should consider such changes in that light. Do we as a nation want to:

1. Change our anti-concentration policy?
2. Eliminate local ownership and control of financial resources?
3. Destroy the dual banking system and diversity of financial regulation?
4. Preclude state legislative authority over financial institutions?
5. Concentrate banking regulation in a single federal agency or committee?

These are not idle questions. They are questions whose answers are essential to a resolution of the debate over the elimination or dilution of the McFadden Act and the Douglas Amendment to the Bank Holding Company Act.

While the questions above provide a comprehensive view of the seriousness of any action that would change the McFadden Act and Douglas Amendment, concern should focus on two fundamental questions which must be answered. First, would the authority to expand interstate ownership actually cure the conditions proponents cite as the major justification for such authority? And second, would such interstate authority reverse--without direct debate--a fundamental American political philosophy favoring local control of local money?

The argument is not against interstate bank services. Indeed, interstate bank services are in place and expanding technological capacities will create greater interstate banking capabilities.

That is not the issue. The issue is whether our nation will retain a diverse, multiple-institutional, locally-owned and controlled system which because of these characteristics is sensitive to the needs of the many and diverse economic areas of the nation.

The issue is not interstate banking but interstate ownership and control that would be buttressed by a monolithic Washington-centered chartering and regulatory structure. And the varied and changing proposals for interstate expansion threaten directly to create that kind of a system--changing 200 years of American policy. It behooves Congress to broaden the debate over interstate ownership and control from the narrow--real as they may be--concerns advanced by some proponents of change, to this more fundamental issue.

The argument that concentration is the major issue is not advanced lightly. The consequences of major concentrations of ownership and control over banking resources must be considered with great care. Further, there are many political and social reasons to view undue concentration of financial resources with great concern. The kind of banking structure that likely would develop raises several issues that require careful consideration and further study.

First, the small number of giant nationwide organizations that would emerge would inevitably "be affected with a government-perceived public interest"--more so than is currently the case with large U.S. banking organizations. A high concentration of banking resources in a few such organizations would make them highly susceptible to greater direct governmental controls and tend to remove them from the market processes to which they are now subject. Paradoxically, proposals for permissive interstate ownership and control under the guise of free enterprise would be the antithesis of free enterprise! Concentration of private power, centralization of government power and greater government control are inter-dependent. Just as it has not been possible to permit large industrial firms to fail (Chrysler and Lockheed being two prime examples), the government also would protect the giant banking organizations that would emerge out of nationwide branching against failure in the conventional sense. Such governmental protection against failure, however, provides protected organizations with a substantial competitive advantage over the non-protected. Such has already been demonstrated.

Additionally, substantial concentration reduces structural diversity. In terms of numbers of organizations, size distribution, organizational form, the variety of services offered, objectives, practices and outlook, variety will diminish to the marketplace's loss. Diversity tends to promote competition and innovation. In and of itself, the current structural arrangement provides small businesses and new bank organizations opportunities that are likely to diminish with changes advocated by some individuals and groups.

The elimination of interstate restrictions by federal fiat would have a serious impact on the dual banking system. States simply would no longer determine the structure best suited to their needs.

The bedrock of our diverse regional economic structure, our banking system that conforms to that structure, and our desire to minimize political control over the nation's financial resources is American policy preventing undue concentration. It is this approach to decentralization that proposals for interstate branching (and bank holding company ownership) threaten, and it is this approach to decentralization that Congress must consider before changing the existing system.

An additional allied question is offered for exploration. Can interstate ownership systems develop so that state control--that is, local political control--can be preserved? Can we find a way to meld the two opposing drives to insure the maintenance of our carefully developed system of political checks and balances? The answer is yes, but the solution lies not with the elimination or dilution of McFadden and Douglas. The principles embodied in these statutes recognize that the individual states can best decide such structure issues. States continually have liberalized limitations on geographic expansion by commercial banks and bank holding companies, even across state lines, and they will continue to do so. But each one acts when it is in the best interest of its citizens to do so. To imply that one approach is optimal for all 50 states is to ignore the existence of our decentralized economic and political heritage.

Finally, all the evidence suggests that today's system serves American businessmen, corporations, governments and households well. The financial needs of large American businesses are met by the major financial institutions; local banks afford small businesses excellent services; state, local and federal governments are well served; and above all and to a degree not found in other nations, consumers enjoy a broad array of financial services. It is our view that the burden of proof that drastic rather than evolutionary change is necessary in such a system lies with proponents of such change. Moreover, if such change would entail a massive shift in a fundamental American policy--it is clear that it would--that change must be totally justified. This has yet to be done.

The CHAIRMAN. Thank you very much, Mr. Bailey. The inserts in the record that you requested will be placed in the record. In addition, we appreciate each of you summarizing your statements. Your full statement will be printed in the record, as well.

Mr. Wagner.

HUNTER O. WAGNER, COMMISSIONER OF FINANCIAL INSTITUTIONS FOR THE STATE OF LOUISIANA, VICE PRESIDENT OF THE NATIONAL ASSOCIATION OF STATE SAVINGS & LOAN SUPERVISORS

Mr. WAGNER. Thank you, Mr. Chairman, and honorable members of this distinguished committee. I certainly appreciate the opportunity this morning to provide the views of the National Association of State Savings and Loan Supervisors. I am the commissioner of financial institutions for the State of Louisiana. Of course, my name is Hunter Wagner. Colloquially, in Louisiana, we say "Hunner," instead of pronouncing the T. I appear today before you as vice president of the National Association of State Savings and Loan Supervisors.

Chairman Garn, your letter of May 12 asked that the members of this panel address the primary issues relating to the "condition and structure of, and competition within, the domestic financial services industry." It's a pleasure to report to you and the committee members that the stability of the savings and loan industry is steadily improving.

THRIFT INSTITUTIONS NOW ABLE TO COMPETE IN FINANCIAL MARKETS

The substantial deregulation of thrift institution assets in the Garn-St Germain Depository Institutions Act of 1982, which I will hereafter refer to as the Garn Act, has provided thrift institutions with additional tools with which to compete in the financial markets. Are institutions able to utilize these empowerments profitably remains a question. The Garn Act empowerments are enjoyed generally by the State-chartered thrift industry through parity or competitive equality statutes. NASS&LS is proud to report that the Federal legislative initiative has stimulated a response within an increasing number of State legislatures.

California, as an example, is dramatic in its State legislative response to Federal thrift institution deregulation. Concurrent with the enactment of the Garn Act, the California Legislature amended its code and granted California-chartered savings and loan associations up to 20 percent of total assets in commercial lending, phased in over a 3-year period; repealed all asset and investment restrictions on service corporation investment; eliminated asset limitation on investment in commercial real estate; and authorized both interindustry merger, sale of assets, conversion and direct savings association investment in mutual fund shares.

A compelling argument in favor of the procompetitive effect of the dual system of financial institution regulation is that, as of this date, applications for approval of the formation of California chartered de novo stock associations have been received by the California Department of Savings and Loans.

Additionally, several other States have begun a comprehensive review of savings association statute and regulation, including my own State of Louisiana. As you can clearly understand, such an undertaking is based upon compromise. The State experience is as diverse as each of the States. In contrast, Louisiana did not appreciably lose its constituency. Thus, we did not have to expand so broadly. However, in Louisiana we have just—in fact, yesterday I appeared in front of the Senate Commerce Committee—and we have a complete recodification of the savings and loan law in Louisiana.

I am happy to say we passed it out of committee. This is the first committee that we have met. We will have to go to the full Senate floor and then of course to the House and the House floor afterward, but it was approved by the committee by a vote of 8 to 0 yesterday.

We did have some testimony to give, about an hour and a half, but generally it was an act of compromise all the way along the line. In Louisiana we have a single unit banking State. We have branches only within the parishes. We call them parishes—but these are the counties in which the institutions are domiciled.

This, of course, had to be a give-or-take situation wherein the independent bankers were actively fighting the mounting effort by larger banks in Louisiana to gain statewide branching and multibank holding companies.

So I addressed myself to the major issues in the recodification, but I left three things alone—statewide branching, savings banks—of which we have none—and the problems between the banks and the savings and loan in Louisiana with respect to public funds. Those three issues I completely eliminated from the bill.

I think we had a good bill, but we did not appreciably lose savings and loan institutions because we were able to track all the things that the Federal institutions were able to give with the single exception of branching. Over the past 2½ years of troubled times, branching in Louisiana has not been a prime concern.

Additionally, several other States have gone in the same direction, and I think many more are continuing.

As to the structure of the domestic financial services industry as it relates to the responsibilities of the Congress, NASS&LS would like to address three issues of primary concern. We would like to speak to geographic realinement of financial institutions, Federal agency reform, and increased product diversity.

CONGRESSIONAL OVERSIGHT ON RECENT ENACTED LEGISLATION

It is imperative that Congress carefully oversee and assess the implementation of the recently enacted legislation. Thrift institutions are still extremely fragile, and it is in the national interest to guide their return to full strength. As deregulation proceeds, congressional oversight should increase in the same proportion.

NASS&LS finds Federal geographic realinement of domestic institutions particularly troublesome.

Congress authorized interstate branching for Federal savings and loan associations last year in section 334 of the Garn Act. NASS&LS encourages this committee to reassess the geographic realinement of Federal associations and place the issue of interstate operation in proper perspective: First, to our knowledge, Federal associations are the only class of nationally chartered institutions which have been given express congressional authorization to branch on an interstate basis; second, Congress intended that this power be implemented only where State law permits, thus preserving the dual system.

Because we believe that the Federal Home Loan Bank Board has lost sight of this perspective, we would like to review these points with you. Congress, responding to a crisis with regard to regulated depository institutions, recommended passage of title I of the Garn Act. Entry by an out-of-State entity into a local market was allowed for a qualified purpose—to stabilize that market and prevent institutional failure, not to promote new operations in a new market. Interstate combination of distressed institutions was the alternative to chaotic disruption of the Nation's capital markets caused by depository failure. In this regard, adjoining States were given priority by Congress over other out-of-State bidders, presumably to protect and stabilize the regional markets. It is clear that interstate combination of depositories is and remains a less preferred alternative.

INTERSTATE COMBINATION OF DISTRESSED INSTITUTIONS

Title III of the Garn Act authorized nonsupervisory interstate branching for Federal saving's and loan associations. The Federal Home Loan Bank Board proposed a regulation implementing section 33A in late April. The proposal was based in part on the Federal Home Loan Bank Board's fear that "If Federal thrifts are not permitted to branch to the same extent as their State-chartered competitors, Federal associations will operate at a competitive disadvantage with the State-chartered institutions." This is news to us. We understand that the limited New England regional reciprocity experiment carries little, if any, momentum toward nationwide interstate operation of State-chartered thrift institutions.

Mr. Chairman, only Alaska, Delaware, and South Dakota permit unqualified entry to out-of-State entities. While individual State legislatures may permit their domiciled institutions to operate across State lines, the legislatures cannot guarantee their welcome in a sister State—a situation analogous to all dressed up and nowhere to go. In the absence of some reciprocal action in the form of an interstate compact or agreement, State legislatures have no power to allow a domestic institution to enter a sister State. We must rely on hard and difficult bargaining to reach an accord within 50 diverse jurisdictions; 14 of the 17 hosts cited by the Federal Home Loan Bank Board require reciprocity. Thrifts can penetrate in another jurisdiction only where its own domicile allows similar entry. This substantial restraint on entry underscores our concern that the Federal Home Loan Bank Board is "crying wolf" with respect to the dire competitive necessity for Federal interstate operation.

If, as stated in the preamble to the proposed rule. "The Board believes that deferral to State law would not unduly disrupt FSLIC supervisory activities and recognizes the interest and significance of State law in interstate transactions," then, as a matter of public policy the members of NASS&LS should assume a direct role in the interpretation of their own diverse State statutes. State/Federal cooperation is essential to the effective functioning of a dual system of financial institution regulation. This relationship will be strengthened by formal recognition of the primary role that State supervisors play.

This could best be accomplished by a certification process under which a State would certify to the Federal Home Loan Bank Board that its laws permit entry by out-of-State institutions. We urge, you, Mr. Chairman, to encourage the Federal Home Loan Bank Board to adopt this certification approach.

Certification would stimulate State legislative review and or an affirmative act to eliminate geographic restrictions. State legislators in New England have acted relative to interstate operation by developing a network of interstate financial institutions' operation on a regional basis. There are still kinks which need to be worked out of this experiment. Review of the problems as they arise in this regional State experiment will only assist Congress in its oversight.

In sum, we submit that the Federal Home Loan Bank Board was given a special dispensation from the Congress to allow a single, distinctly limited class of depository federally chartered savings and loan associations to branch across State lines. The legislative history clearly indicates that Congress intended to restrict this branching to those States which permit penetration by out-of-State thrifts. This is a highly restrained framework within which Congress has allowed the Federal Home Loan Bank Board to proceed. We are concerned with its abuse by the sole regulator entrusted by this body with the legal power to authorize the interstate operation of domestic financial institutions. Serious regard for the stability of this Nation's capital markets mandates that this Congress carefully scrutinize the actions of the Federal Home Loan Bank Board by requiring Federal reliance on State certification that their host statutes will in fact allow market entry.

FEDERAL AGENCY REFORM AND CONSOLIDATION

Second, NASS&LS would like to address the issue of Federal agency reform and consolidation.

In most every State there are State-licensed savings and loan associations chartered by the State officials who comprise NASS&LS. Such State-chartered institutions derive their authority to receive and lend money from State, not Federal law. About 98 percent of the State-chartered savings and loan associations have deposit account insurance usually required by State statute from the Federal Savings and Loan Insurance Corporation. It is primarily through the FSLIC that the Federal Government regulates State-chartered savings and loan associations. The FSLIC has a wholly appropriate interest in the safety and soundness of the State-chartered institutions whose accounts it insures. However, the Federal agency consistently intrudes into the operations of State-chartered FSLIC-insured institutions as a policymaker as opposed to an insurer.

Federal controls over State-chartered entities represent an unnecessary level of regulation in an area where greater deference should be given to State regulatory responsibilities. For example, responsibility for the examination of State-chartered FSLIC-insured institutions should be delegated directly to the States. Deferral to the States would reduce examination costs, reduce the number of Federal examiners needed, and place the examination of State-chartered savings and loans associations with the chartering agency.

To restrain this Federal preemption of State authority under the guise of safety and soundness, we advocate separation of the FSLIC from the Federal Home Loan Bank Board. It is the NASS&LS view that such separation would statutorily commit the FSLIC to the sole function for which it was created, to insure the accounts of regulated savings and loan associations. In conjunction with this proposed separation, we would further request that the Congress impose a strict mandate that the separate agencies operate under guidelines which conform with the separate and distinct regulatory responsibilities of each agency. The promoter should not be the insurer. The inherent conflicts of interest in the chartering and insuring functions will be eliminated by bifarcating these duties.

With respect to the Federal deposit insurance function and the various proposed alternatives, we would reserve comment until these alternatives, including the variable rate risk indexed premium, have been carefully considered.

AMENDMENTS TO MAINTAIN A COMPETITIVE EQUILIBRIUM

Finally, Mr. Chairman, you indicated last year that this committee would revive proposed amendments to the Glass-Steagall Act. NASS&LS supports the statutory amendment of the Glass-Steagall Act, insofar as it would authorize savings and loan associations to engage in securities activities. The amendments are consistent with the congressional intent to maintain a competitive equilibrium for all domestic providers of financial products or services. While we have not considered in depth the appropriate regulatory framework within which financial institutions should engage in securities activities, it is our view that supervisory function should follow each new power. Where financial service providers offer combined services outside the traditional realm of supervisory expertise or regulation—for example, securities, insurance, the so-called "family financial center" approach, the regulator with jurisdiction over each function should supervise and examine each such function or service.

In conclusion, I want to thank this committee for the opportunity to present our views before this distinguished group. We have confined our comments to those issues critical to the role of the States in the supervision of the institutions which they license. Your decisions on these issues will certainly have an important effect on the dual system of chartering and supervision of savings associations.

I thank you.

[The complete statement follows:]

STATEMENT OF

HUNTER O. WAGNER, JR.

COMMISSIONER OF THE DEPARTMENT OF
FINANCIAL INSTITUTIONS
STATE OF LOUISIANA

ON BEHALF OF

THE NATIONAL ASSOCIATION OF
STATE SAVINGS AND LOAN SUPERVISORS*
1983 HEARINGS ON OVERSIGHT OF DOMESTIC FINANCIAL SERVICES INDUSTRY
BEFORE
THE SENATE BANKING HOUSING AND URBAN AFFAIRS COMMITTEE

UNITED STATES SENATE

MAY 20, 1983

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* THE MEMBERS OF THE NATIONAL ASSOCIATION OF STATE SAVINGS AND LOAN SUPERVISORS ARE THE STATE OFFICIALS WHO REGULATE STATE-CHARTERED SAVINGS AND LOAN INSTITUTIONS IN THE SEVERAL STATES AND TERRITORIES. THE MEMBERS OF NASS&LS SUPERVISE AND EXAMINE SOME 2,300 STATE-CHARTERED INSTITUTIONS WITH ASSETS OF APPROXIMATELY $250 BILLION. THE PRINCIPAL OFFICERS OF THE ASSOCIATION ARE DAVID L. PAUL, PRESIDENT OF THE ASSOCIATION, COMMISSIONER OF THE SAVINGS AND LOAN COMMISSION FOR THE STATE OF COLORADO; HUNTER O. WAGNER, JR., VICE PRESIDENT OF THE ASSOCIATION, COMMISSIONER OF THE DEPARTMENT OF FINANCIAL INSTITUTIONS, STATE OF LOUISIANA; AND GEORGE F. McGUIRE, JR., SECRETARY-TREASURER OF THE ASSOCIATION; DIRECTOR OF THE DIVISION OF SAVINGS AND LOAN SUPERVISION FOR THE STATE OF MISSOURI.

Mr. Chairman and members of this distinguished Committee, I appreciate this opportunity to provide the views of the National Association of State Savings and Loan Supervisors. My name is Hunter Wagner, and I am the Commissioner of the Department of Financial Institutions for the State of Louisiana. I appear today before you as the Vice President of the National Association of State Savings and Loan Supervisors.

CONDITION OF THE DOMESTIC FINANCIAL SERVICES INDUSTRY

Chairman Garn, your letter of May 12 asked that the members of this panel address the primary issues relating to the "condition and structure of, and competition within, the domestic financial services industry". It is a pleasure to report to you and the Committee members that the stability of the savings and loan industry is steadily improving. The substantial deregulation of thrift institution assets in the Garn-St Germain Depository Institutions Act of 1982 ("Garn Act") has provided thrift institutions with additional tools with which to compete in the financial markets. The Garn Act empowerments are enjoyed generally by the state-chartered thrift industry through parity or competitive equality statutes. NASS&LS is proud to report that the federal legislative initiative has stimulated a response within an increasing number of state legislatures.

California is a dramatic example of this state response to federal thrift institution deregulation. Concurrent with the enactment of the Garn Act, the California legislature amended its code

AND GRANTED CALIFORNIA CHARTERED SAVINGS ASSOCIATIONS COMMERCIAL LENDING AUTHORITY (PHASED-IN TO A MAXIMUM OF 20% OF TOTAL ASSOCIATION ASSETS OVER THREE YEARS); REPEALED ALL ASSET AND INVESTMENT RESTRICTIONS ON SERVICE CORPORATION INVESTMENT; ELIMINATED ASSET LIMITATION ON INVESTMENT IN COMMERCIAL REAL ESTATE; AND AUTHORIZED BOTH INTERINDUSTRY MERGER, SALE OF ASSETS AND CONVERSION AND DIRECT SAVINGS ASSOCIATION INVESTMENT IN MUTUAL FUND SHARES. A COMPELLING ARGUMENT IN FAVOR OF THE PRO-COMPETITIVE EFFECT OF THE DUAL SYSTEM OF FINANCIAL INSTITUTION REGULATION IS THAT AS OF THIS DATE NINETY APPLICATIONS FOR APPROVAL OF THE FORMATION OF CALIFORNIA CHARTERED _DE NOVO_ STOCK ASSOCIATIONS HAVE BEEN RECEIVED BY THE CALIFORNIA DEPARTMENT OF SAVINGS AND LOAN.

ADDITIONALLY, SEVERAL OTHER STATES HAVE BEGUN A COMPREHENSIVE REVIEW OF SAVINGS ASSOCIATION STATUTE AND REGULATION INCLUDING MY OWN STATE OF LOUISIANA.

STRUCTURE OF THE DOMESTIC FINANCIAL SERVICES INDUSTRY

AS TO THE STRUCTURE OF THE DOMESTIC FINANCIAL SERVICES INDUSTRY AS IT RELATES TO RESPONSIBILITIES OF THE CONGRESS, NASS&LS WOULD LIKE TO ADDRESS THREE ISSUES OF PRIMARY CONCERN. WE WOULD LIKE TO SPEAK TO GEOGRAPHIC REALIGNMENT OF FINANCIAL INSTITUTIONS, FEDERAL AGENCY REFORM AND PRODUCT DIVERSITY.

IT IS IMPERATIVE THAT THE CONGRESS CAREFULLY OVERSEE AND ASSESS THE IMPLEMENTATION OF THE RECENTLY ENACTED LEGISLATION. THE GARN ACT SHIFTED THE EMPHASIS OF OUR NATION'S REGULATED DEPOSITORIES AWAY FROM SPECIALIZED PRODUCTS AND FUNCTION. REALIGNMENT OF THE THRIFT INSTITUTION'S ASSETS MUST BE ACCOMPLISHED RATIONALLY TO ENSURE THE MAINTENANCE OF CORPORATE STABILITY AND COMPETITIVE EQUALITY FOR ALL ENTRANTS INTO THE DEPOSIT SERVICES MARKET. THRIFT INSTITUTIONS ARE STILL VERY FRAGILE AND IT IS IN THE NATIONAL INTEREST TO GUIDE THEIR RETURN TO FULL STRENGTH. DEVELOPMENT OF THE VARIETY OF NEWLY AVAILABLE PRODUCTS MUST PROCEED WITH MEASURED PACE. AS DEREGULATION PROCEEDS, CONGRESSIONAL OVERSIGHT SHOULD INCREASE.

NASS&LS FINDS FEDERAL GEOGRAPHIC REALIGNMENT OF DOMESTIC INSTITUTIONS PARTICULARLY TROUBLESOME. NASS&LS FIRST OPPOSED THE POLICY OF INTERSTATE BRANCHING FOR FEDERAL SAVINGS AND LOAN ASSOCIATIONS IN JULY 1976 WHEN WE OBJECTED TO THE PROPOSED MERGER OF A FEDERAL SAVINGS AND LOAN ASSOCIATION IN PUERTO RICO WITH A FEDERAL SAVINGS AND LOAN ASSOCIATION IN NEW YORK. WE ARGUED THAT THE FHLBB LACKED THE AUTHORITY TO APPROVE THE MERGER; AND "IF CONGRESS HAD INTENDED TO CREATE A SYSTEM OF INTERSTATE SAVINGS AND LOAN ASSOCIATION OPERATION IT COULD HAVE EASILY DONE SO".

CONGRESS AUTHORIZED INTERSTATE BRANCHING FOR FEDERAL SAVINGS AND LOAN ASSOCIATIONS LAST YEAR IN SECTION 334 OF THE GARN ACT. NASS&LS ENCOURAGES THIS COMMITTEE TO REASSESS THE GEOGRAPHIC REALIGNMENT OF FEDERAL ASSOCIATIONS AND PLACE THE ISSUE OF INTERSTATE

OPERATION IN PROPER PERSPECTIVE: FIRST, TO OUR KNOWLEDGE FEDERAL ASSOCIATIONS ARE THE ONLY CLASS OF NATIONALLY CHARTERED INSTITUTIONS WHICH HAVE BEEN GIVEN EXPRESS CONGRESSIONAL AUTHORIZATION TO BRANCH ON AN INTERSTATE BASIS; SECOND, CONGRESS INTENDED THAT THIS POWER BE IMPLEMENTED ONLY WHERE STATE LAW PERMITS, THUS PRESERVING THE DUAL SYSTEM.

BECAUSE WE BELIEVE THAT THE FEDERAL HOME LOAN BANK BOARD ("FHLBB") HAS LOST SIGHT OF THIS PERSPECTIVE, WE WOULD LIKE TO REVIEW THESE POINTS WITH YOU. CONGRESS, RESPONDING TO A CRISIS FOR REGULATED DEPOSITORY INSTITUTIONS, RECOMMENDED PASSAGE OF TITLE I OF THE GARN ACT. TITLE I "PROVIDE[D] THE AGENCIES WITH BETTER TOOLS FOR DEALING WITH FAILING INSTITUTIONS AND . . . STRENGTHEN[ED] THE RESOURCES OF THE FEDERAL INSURANCE FUNDS". TITLE I EXPANDED FEDERAL SUPERVISORY AUTHORITY TO INCLUDE INTERSTATE COMBINATIONS ONLY "WHERE SEVERE FINANCIAL CONDITIONS EXIST WHICH THREATEN THE STABILITY OF A SIGNIFICANT NUMBER OF INSURED INSTITUTIONS OR OF INSURED INSTITUTIONS POSSESSING SIGNIFICANT FINANCIAL RESOURCES". ENTRY BY AN OUT-OF-STATE ENTITY INTO A LOCAL MARKET WAS ALLOWED FOR A QUALIFIED PURPOSE -- TO STABILIZE THAT MARKET AND PREVENT INSTITUTIONAL FAILURE, NOT TO PROMOTE NEW OPERATIONS IN A NEW MARKET. INTERSTATE COMBINATION OF DISTRESSED INSTITUTIONS WAS THE ALTERNATIVE TO CHAOTIC DISRUPTION OF THE NATION'S CAPITAL MARKETS CAUSED BY DEPOSITORY FAILURE. IN THIS REGARD, ADJOINING STATES WERE GIVEN PRIORITY BY THE CONGRESS OVER OTHER OUT-OF-STATE BIDDERS PRESUMABLY

TO PROTECT AND STABILIZE REGIONAL MARKETS. IT IS CLEAR THAT INTERSTATE COMBINATION OF DEPOSITORIES IS AND REMAINS A LESS PREFERRED ALTERNATIVE.

TITLE III OF THE GARN ACT AUTHORIZES NONSUPERVISORY INTERSTATE BRANCHING FOR FEDERAL ASSOCIATIONS. A MERE SIX MONTHS FOLLOWING ENACTMENT OF THE GARN ACT, THE FHLBB PROPOSED A SWEEPING RULE TO ALLOW, CONSISTENT WITH §334 OF THE GARN ACT, NONSUPERVISORY INTERSTATE MERGERS, ACQUISITIONS AND ESTABLISHMENT OF BRANCHES WHERE STATE LAW SPECIFICALLY PERMITS ENTRY BY OUT-OF-STATE INSTITUTIONS. THE PROPOSAL WAS BASED IN PART ON THE FHLBB'S FEAR THAT "IF FEDERAL THRIFTS ARE NOT PERMITTED TO BRANCH TO THE SAME EXTENT AS THEIR STATE-CHARTERED COMPETITORS, (FEDERAL ASSOCIATIONS) WILL OPERATE AT A COMPETITIVE DISADVANTAGE WITH THE STATE-CHARTERED INSTITUTIONS". THIS IS NEWS TO US. WE UNDERSTAND THAT, SAVE FOR THE LIMITED NEW ENGLAND REGIONAL RECIPROCITY EXPERIMENT, THERE IS LITTLE, IF ANY, MOMENTUM TOWARD INTERSTATE OPERATION OF STATE-CHARTERED THRIFT INSTITUTIONS. A SURVEY OF THE 17 STATUTES CITED BY THE FHLBB AS STATUTORY "HOSTS" FOR FEDERAL SAVINGS AND LOAN ASSOCIATIONS REVEALS ONLY THREE WHICH PERMIT UNQUALIFIED ENTRY. MR. CHAIRMAN, ONLY ALASKA, DELAWARE, AND SOUTH DAKOTA PERMIT UNQUALIFIED ENTRY TO OUT-OF-STATE ENTITIES. WHILE INDIVIDUAL STATE LEGISLATURES MAY PERMIT THEIR DOMICILED INSTITUTIONS TO OPERATE ACROSS STATE LINES, THE LEGISLATURES CANNOT GUARANTEE THEIR WELCOME IN A SISTER STATE -- A SITUATION ANALOGOUS TO "ALL DRESSED UP AND NOWHERE TO GO". IN THE

ABSENCE OF SOME RECIPROCAL ACTION IN THE FORM OF INTERSTATE COMPACT OR AGREEMENT, STATE LEGISLATURES HAVE NO POWER TO ALLOW A DOMESTIC INSTITUTION TO ENTER A SISTER STATE. WE MUST RELY ON HARD AND DIFFICULT BARGAINING TO REACH AN ACCORD WITHIN FIFTY DIVERSE JURISDICTIONS. FOURTEEN OF THE 17 "HOSTS" CITED BY THE FHLBB REQUIRE RECIPROCITY (I.E. THRIFTS CAN PENETRATE ANOTHER JURISDICTION ONLY WHERE ITS OWN DOMICILE ALLOWS SIMILAR ENTRY). THIS SUBSTANTIAL RESTRAINT ON ENTRY UNDERSCORES OUR CONCERN THAT THE FHLBB IS "CRYING WOLF" WITH RESPECT TO THE DIRE COMPETITIVE NECESSITY FOR FEDERAL INTERSTATE OPERATION.

STATE-FEDERAL COOPERATION IS ESSENTIAL TO THE EFFECTIVE FUNCTIONING OF THE DUAL SYSTEM OF FINANCIAL INSTITUTION REGULATION. THIS RELATIONSHIP WILL BE STRENGTHENED BY FORMAL RECOGNITION OF THE PRIMARY ROLE THAT STATE SUPERVISION PLAYS.

IF, AS STATED IN THE PREAMBLE TO THE PROPOSED RULE, "THE BOARD BELIEVES THAT DEFERRAL TO STATE LAW WOULD NOT UNDULY DISRUPT FSLIC SUPERVISORY ACTIVITIES AND . . . RECOGNIZE(S) THE INTEREST AND SIGNIFICANCE OF STATE LAW IN INTERSTATE TRANSACTIONS", THEN, AS A MATTER OF PUBLIC POLICY, THE MEMBERS OF NASS&LS SHOULD ASSUME A DIRECT ROLE IN THE INTERPRETATION OF THEIR OWN, DIVERSE STATE STATUTES.

THIS COULD BE BEST ACCOMPLISHED BY A CERTIFICATION PROCESS UNDER WHICH A STATE WOULD CERTIFY TO THE BOARD THAT ITS LAWS PERMIT ENTRY BY OUT-OF-STATE INSTITUTIONS. WE URGE CONGRESS TO ENCOURAGE THE BOARD TO ADOPT THIS CERTIFICATION APPROACH.

CERTIFICATION WOULD STIMULATE STATE LEGISLATIVE REVIEW AND/OR AN AFFIRMATIVE ACT TO ELIMINATE GEOGRAPHIC RESTRICTIONS. STATE LEGISLATURES IN NEW ENGLAND HAVE ACTED RELATIVE TO INTERSTATE OPERATION BY DEVELOPING A NETWORK OF INTERSTATE FINANCIAL INSTITUTIONS' OPERATION ON A REGIONAL BASIS. ONLY TWO OF THOSE SIX NEW ENGLAND STATES HAVE ENACTED THE RECIPROCAL LEGISLATION REQUIRED TO ALLOW REGIONAL ENTRY WHILE THE OTHER FOUR HAVE VARIOUS FORMS OF INTERSTATE BANKING BILLS PENDING. CONSTITUTIONAL ISSUES HAVE ARISEN WITH RESPECT TO DISCRIMINATION IN FAVOR OF SOME STATES AND AGAINST OTHERS. FINANCIAL INSTITUTIONS IN STATES OUTSIDE THE REGION HAVE THREATENED TO FILE SUIT AGAINST VARIOUS NEW ENGLAND STATE BANKING DEPARTMENTS IF THE STATE LAW DENIES ENTRY OUTSIDE THE REGION. ALSO, THE QUESTION OF THE EFFECT OF THE DOUGLAS AMENDMENT RESTRICTIONS ON THE INTERSTATE ACQUISITION BY BANK HOLDING COMPANIES REMAINS TO BE RESOLVED. REVIEW OF THE PROBLEMS AS THEY ARISE IN THIS REGIONAL STATE EXPERIMENT WILL ONLY ASSIST CONGRESS IN ITS OVERSIGHT.

IN SUM, WE SUBMIT THAT THE FHLBB WAS GIVEN A SPECIAL DISPENSATION FROM THE CONGRESS TO ALLOW A SINGLE, DISTINCTLY LIMITED CLASS OF DEPOSITORY--FEDERALLY CHARTERED SAVINGS AND LOAN ASSOCIATIONS -- TO BRANCH ACROSS STATE LINES. THE LEGISLATIVE HISTORY CLEARLY INDICATES THAT CONGRESS INTENDED TO RESTRICT THIS BRANCHING TO "THOSE STATES WHICH PERMIT PENETRATION BY OUT-OF-STATE THRIFTS". THIS IS A HIGHLY RESTRAINED FRAMEWORK WITHIN WHICH THE CONGRESS HAS ALLOWED THE FHLBB TO PROCEED. WE ARE CONCERNED WITH ITS ABUSE BY

THE SOLE REGULATOR ENTRUSTED BY THIS BODY WITH THE LEGAL POWER TO AUTHORIZE THE INTERSTATE OPERATION OF DOMESTIC FINANCIAL INSTITUTIONS. SERIOUS REGARD FOR THE STABILITY OF THIS NATION'S CAPITAL MARKETS MANDATES THAT THIS CONGRESS CAREFULLY SCRUTINIZE THE FHLBB BY REQUIRING FEDERAL RELIANCE ON STATE CERTIFICATION THAT THEIR "HOST" STATUTES IN FACT WILL ALLOW MARKET ENTRY.

SECOND, NASS&LS WOULD LIKE TO ADDRESS THE ISSUE OF FEDERAL AGENCY REFORM AND CONSOLIDATION.

IN MOST EVERY STATE THERE ARE STATE LICENSED SAVINGS AND LOAN ASSOCIATIONS CHARTERED BY THE STATE OFFICIALS WHO COMPRISE NASS&LS. SUCH STATE-CHARTERED INSTITUTIONS DERIVE THEIR AUTHORITY TO RECEIVE AND LEND MONEY FROM STATE, NOT FEDERAL LAW. ABOUT 98 PERCENT OF THE STATE-CHARTERED SAVINGS AND LOAN ASSOCIATIONS HAVE DEPOSIT ACCOUNT INSURANCE USUALLY REQUIRED BY STATE STATUTE FROM THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION ("FSLIC"). IT IS PRIMARILY THROUGH THE FSLIC THAT THE FEDERAL GOVERNMENT REGULATES STATE-CHARTERED SAVINGS AND LOAN ASSOCIATIONS. THE FSLIC HAS A WHOLLY APPROPRIATE INTEREST IN THE SAFETY AND SOUNDNESS OF THE STATE-CHARTERED INSTITUTIONS WHOSE ACCOUNTS IT INSURES. HOWEVER, THE FEDERAL AGENCY CONSISTENTLY INTRUDES INTO THE OPERATIONS OF STATE-CHARTERED FSLIC-INSURED INSTITUTIONS AS A POLICY-MAKER INSTEAD OF AS AN INSURER.

FEDERAL CONTROLS OVER STATE-CHARTERED ENTITIES REPRESENT AN UNNECESSARY LEVEL OF REGULATION AND AN AREA WHERE GREATER DEFERENCE SHOULD BE GIVEN TO STATE REGULATORY RESPONSIBILITIES. FOR EXAMPLE, RESPONSIBILITY FOR THE EXAMINATION OF STATE-CHARTERED, FSLIC-INSURED INSTITUTIONS SHOULD BE DELEGATED TO THE STATES. DEFERRAL TO THE STATES WOULD REDUCE EXAMINATION COSTS, REDUCE THE NUMBER OF FEDERAL EXAMINERS NEEDED, AND PLACE THE EXAMINATION OF STATE-CHARTERED SAVINGS AND LOAN ASSOCIATIONS WITH THE CHARTERING AGENCY.

NOT ONLY IS A STATE-CHARTERED INSTITUTION BURDENED FINANCIALLY BY THE IMPOSITION OF A FEDERAL ASSESSMENT WHICH MUST BE ADDED TO THE REGULAR STATE ASSESSMENT, BUT THE COST ATTENDANT TO JOINT EXAMINATION (FEDERAL AND STATE EXAMINERS WORKING CONCURRENTLY) IS GREATER THAN STATE ONLY EXAMINATION. FINALLY, THE FSLIC ANNUALLY UNDERWRITES THE COSTS OF FEDERAL EXAMINATIONS AND THE OFFICE OF EXAMINATIONS AND SUPERVISION OF THE FHLBB. STATE-CHARTERED INSTITUTIONS DO NOT RECEIVE THEIR PROPORTIONATE SHARE OF THIS SUBSIDY EVEN THOUGH THEY PAY EQUALLY WITH FEDERALLY CHARTERED INSTITUTIONS INTO THE FSLIC.

TO RESTRAIN THIS FEDERAL PREEMPTION OF STATE AUTHORITY UNDER THE GUISE OF SAFETY AND SOUNDNESS, WE ADVOCATE SEPARATION OF THE FSLIC FROM THE FHLBB. IT IS NASS&LS VIEW THAT SUCH SEPARATION WOULD STATUTORILY COMMIT THE FSLIC TO THE SOLE FUNCTION FOR WHICH IT WAS CREATED -- TO INSURE THE ACCOUNTS OF REGULATED SAVINGS AND LOAN

ASSOCIATIONS. IN CONJUNCTION WITH THIS PROPOSED SEPARATION, WE WOULD FURTHER REQUEST THAT THE CONGRESS IMPOSE A STRICT MANDATE THAT THE SEPARATE AGENCIES OPERATE UNDER GUIDELINES WHICH COMPORT WITH THE SEPARATE AND DISTINCT REGULATORY RESPONSIBILITIES OF EACH AGENCY. THE PROMOTOR SHOULD NOT BE THE INSURER. THE INHERENT CONFLICTS OF INTEREST IN THE CHARTERING AND INSURING FUNCTIONS WILL BE ELIMINATED BY BIFURCATING THESE DUTIES.

WITH RESPECT TO THE FEDERAL DEPOSIT INSURANCE FUNCTION AND THE VARIOUS PROPOSED ALTERNATIVES, WE WOULD RESERVE COMMENT UNTIL THESE ALTERNATIVES, INCLUDING A VARIABLE RATE RISK-INDEXED PREMIUM, HAVE BEEN CAREFULLY CONSIDERED.

FINALLY, MR. CHAIRMAN, YOU INDICATED LAST YEAR THAT THIS COMMITTEE WOULD REVIVE PROPOSED AMENDMENTS TO THE GLASS-STEAGALL ACT. NASS&LS SUPPORTS THE STATUTORY AMENDMENT OF THE GLASS-STEAGALL ACT INSOFAR AS IT WOULD AUTHORIZE SAVINGS AND LOAN ASSOCIATIONS TO ENGAGE IN SECURITIES ACTIVITIES. THE AMENDMENTS ARE CONSISTENT WITH THE CONGRESSIONAL INTENT TO MAINTAIN A COMPETITIVE EQUILIBRIUM FOR ALL DOMESTIC PROVIDERS OF FINANCIAL PRODUCTS OR SERVICES. WHILE WE HAVE NOT CONSIDERED IN DEPTH THE APPROPRIATE REGULATORY FRAMEWORK WITHIN WHICH FINANCIAL INSTITUTIONS SHOULD ENGAGE IN SECURITIES ACTIVITIES, IT IS OUR VIEW THAT SUPERVISORY FUNCTION SHOULD FOLLOW EACH NEW POWER. WHERE FINANCIAL SERVICE PROVIDERS OFFER COMBINED SERVICES OUTSIDE THE TRADITIONAL REALM OF SUPERVISORY EXPERTISE OR

REGULATION (I.E., SECURITIES, INSURANCE),--"THE FAMILY FINANCIAL CENTER" APPROACH--THE REGULATOR WITH JURISDICTION OVER EACH FUNCTION SHOULD SUPERVISE AND EXAMINE EACH SUCH SERVICE OR FUNCTION.

CONCLUSION

THANK YOU FOR THIS OPPORTUNITY TO PRESENT OUR VIEWS BEFORE THIS DISTINGUISHED COMMITTEE. WE HAVE CONFINED OUR COMMENTS TO THOSE ISSUES CRITICAL TO THE ROLE OF THE STATES IN THE SUPERVISION OF THE INSTITUTIONS WHICH THEY LICENSE. YOUR DECISIONS ON THESE ISSUES WILL HAVE AN IMPORTANT EFFECT ON THE DUAL SYSTEM OF CHARTERING AND SUPERVISION OF SAVINGS ASSOCIATIONS.

The CHAIRMAN. Thank you, Mr. Wagner. Mr. Carlson.

JACK CARLSON, CHIEF OF FINANCIAL SERVICES REGULATION OF THE DEPARTMENT OF CORPORATIONS FOR THE STATE OF CALIFORNIA, PRESIDENT OF THE NATIONAL ASSOCIATION OF STATE CREDIT UNION SUPERVISORS

Mr. CARLSON. Thank you, Mr. Chairman. My name is Jack Carlson. I'm president of the National Association of State Credit Union Supervisors and Chief of Financial Services Regulation for the Department of Corporations of the State of California.

In addition to my responsibilities over credit unions in the State of California, I also oversee industrial loan companies and consumer credit lenders. The National Association of State Credit Union Supervisions is an association of all 47 State credit union supervisory departments, plus the Commonwealth of Puerto Rico. Our members are responsible for chartering, regulating, and supervising the Nation's approximately 9,000 State-chartered credit unions and 19 State shared credit union insurance funds operating in 26 States, insuring 3,210 State-chartered credit unions.

Many States have moved to deregulate State-chartered credit unions prior to the recent deregulatory initiatives at the Federal level. Dividend rates for State-chartered credit unions have been removed in most States, and the States are accorded a great deal of flexibility with regard to the powers and services that can be offered by State-chartered credit unions.

Twenty-nine State laws contain the Federal parity known as the "wild card" provision that allows State-chartered credit unions to exercise the same powers that Federal credit unions have within their respective States.

OPPOSITION TO MERGER

I come to you this morning with only one item to address. That is relative to the current discussions to combine the Federal financial regulatory agencies and/or insurance funds. NASCUS joins with the Credit Union National Association and the National Association of Federal Credit Unions and the National Credit Union Administation in opposition to the merger of the NCUA and the National Credit Union Insurance Fund with other agencies or insurance funds.

We feel that NCUA and NCUSIF should be kept apart from banking and savings and loan interests for the following reasons:

One, is the decisionmaking process. In a consolidation, the decisionmaking process will be severely altered with individuals that have no credit union experience making insurance decisions for credit unions. Credit unions are democratically controlled, cooperative financial institutions which serve limited segments of the general population. As such, their operations, management practices and problems are far different from those problems encountered by banks and savings and loans.

The Credit Union Insurance Fund has traditionally sought innovative solutions to credit union problems. For example, sponsor closings, plant layoffs, regional and local economic downturns and sources and uses of liquidity are unique to credit unions and require credit union solutions, not banking and savings and loan solutions. Although the thoughts behind a consolidation may be well intended, we are convinced that with the FDIC as the major force in a combined insurance agency, there will be a natural tendency to solve all credit problems with banking solutions. We view such actions as detrimental to the future of the credit union movement.

The working relationship between State and Federal regulators. Since the inception of the National Credit Shared Insurance Fund in 1970, the NCUA has relied on the issuance of State examination reports on the condition of State-chartered/federally insured credit unions. The National Credit Union Administation has also relied upon good communication between State supervisors and NCUA personnel with respect to credit unions that require assistance.

NCUA/NASCUS memorandum of understanding. For the first 12 years, this partnership was an informal one. In 1982, the NCUA Board, in an open public session, ratified a memorandum of understanding between NASCUS, on behalf of all State credit union supervisors and the NCUA with respect to outlining the areas of mutual cooperation between State and Federal regulators. A document such as our joint memorandum of understanding is only of value if both sides opening commit to implement in good faith the principles that are embodied in them. Both the NCUA and the State Credit Union Supervisors have made that commitment and the arrangement is working well.

Item 2, Federal personnel ceilings: Federal personnel ceilings have made it difficult, if not impossible, for the NCUA to obtain additional examiner staff to examine State-chartered/federally insured credit unions. The NCUA has, therefore, been accepting State examination reports, thereby saving credit unions the cost of duplicate examinations.

Three, the Federal Credit Union Act.

The Federal Credit Union Act calls for the NCUA to "make use of state examination reports." To date, the NCUA has been following the wording and intent of the FCU Act.

Four, State modification.

Many States have modified their examination programs to provide additional information which the NCUA needs to make an informed analysis of the condition of insured credit unions.

The concept of merging the NCUA with the regulatory agencies for banks and savings and loans will serve to weaken the traditional advocacy role of the National Credit Union Administration. Such previous examples have included support for a central liquidity facility, increased insurance coverage and limited authority for Federal credit unions to offer home mortgages. If credit union regulation at the Federal level had been part of an omnibus Federal financial regulatory agency, it is questionable as to whether the organized credit union industry would have had executive branch support for the aforementioned programs.

In summary, from the State credit union regulatory perspective, we are satisfied with the current Federal financial institution regulatory framework. In the credit union industry, we have not witnessed an excessive overlap between State and Federal regulatory authorities. Our joint memorandum of understanding with the NCUA is working well. We feel that a consolidation will naturally lead to excessive Federal duplication of State regulations. Current NCUA staff know and understand State credit union supervisors, and this relationship will be severely altered in a consolidation.

Thank you, Mr. Chairman, for allowing me to address you this morning.

[The complete statement follows:]

TESTIMONY

OF

JACK A. CARLSON

PRESIDENT

NATIONAL ASSOCIATION OF STATE CREDIT UNION SUPERVISORS

INTRODUCTION

Mr. Chairman, my name is Jack Carlson. I am President of the National Association of State Credit Union Supervisors and Chief of Financial Services Regulation for the Department of Corporations for the State of California.

The National Association of State Credit Union Supervisors is the association of all forty-seven state credit union supervisory departments, plus the Commonwealth of Puerto Rico. Our members are responsible for chartering, regulating and supervising the nation's approximate 9,000 state-chartered credit unions.

I am the first person on behalf of NASCUS to testify before a Congressional Committee. In the past, we have submitted comments for the record only. We appreciate the invitation and opportunity to appear before your committee today.

Over the past several weeks, you have received testimony from CUNA, NAFCU and NCUA concerning the condition of the credit union industry, and what legislative changes are needed.

Many states have moved to deregulate state-chartered credit unions prior to the recent deregulatory initiatives at the federal level. Recent surveys conducted by our national office have revealed that dividend rates for state-chartered credit unions have been removed in most states and the states afford a great deal of flexibility with regard to powers and services that can be offered by state-chartered credit unions. For example, recent NASCUS surveys have shown that twenty-five (25) states allow for real estate loans by credit unions; twenty-three (23) states allow commercial or business-type loans to be made to credit union members; and twenty-nine state (29) laws contain a federal parity (also known as a wild card) provision that allows state-chartered credit unions to exercise the same powers that federal credit unions have within their respective states.

Overall, we do not have a very big "wish list" to bring before you today. In fact, we have only one item on our list. That item is relative to the current discussion to combine the federal financial regulatory agencies and/or insurance funds.

We are opposed to the merger of the NCUA and/or NCUSIF with any other agencies or insurance funds.

We feel that the NCUA and NCUSIF should be kept apart from banking and savings and loan interests for the following reasons:

DECISION-MAKING PROCESS

In a consolidation, decision-making process will be severely altered with individuals that have no credit union experience making insurance decisions for credit unions. Credit unions are democratically controlled, co-operative financial institutions which serve limited segments of the general population. As such, their operations, management practices, and problems are far different from those problems encountered by banks and savings and loans.

The NCUSIF has traditionally sought innovative solutions to credit union problems. For example, sponsor closings, plant layoffs, regional and local economic down-turns, and sources and uses of liquidity, are unique to credit unions and require credit union solutions, not banking or savings and loan solutions. Although the thoughts behind a consolidation may be well intended, we are convinced that with the FDIC as the major force in a combined insurance agency, there will be a natural tendency to solve all credit union problems with banking solutions. We view such action as detrimental to the future of the credit union movement.

WORKING RELATIONSHIP BETWEEN STATE AND FEDERAL REGULATORS

Since the inception of the NCUSIF in 1970, the NCUA has relied on the acceptance of state examination reports on the condition of state-chartered/federally insured credit unions. The NCUA has also relied upon good communication between state supervisors and NCUA personnel with respect to credit unions that require assistance.

1. Memorandum of Understanding

For the first twelve (12) years, this partnership was an informal one. In April of 1982, the NCUA Board in an open public session, ratified a Memorandum of Understanding between NASCUS (on behalf of all state credit union supervisors) and NCUA with respect to outlining areas of mutual cooperation between state and federal regulators. (See attached Exhibit.)

A document such as our joint memorandum of understanding is only of value if both sides openly commit to implement in good faith the principles that are embodied in it. Both the NCUA and state credit union supervisors have made that commitment, and the arrangement is working well.

2. Federal Personnel Ceilings

Federal personnel ceilings have made it difficult, if not impossible, for the NCUA to obtain additional examiners to examine state-chartered/federally insured credit unions. The NCUA has correctly been accepting state examination reports, and thereby saving credit unions the cost of duplicate examinations.

3. Federal Credit Union Act

The Federal Credit Union Act calls for the NCUA to "make use of state examination reports". To date, the NCUA has been following the wording and intent of the FCU Act.

4. State Modification

Many states have modified their examination programs to provide additional information which the NCUA needs to make an informed analysis of the condition of the insured credit unions.

ADVOCACY ROLE

The concept of merging the NCUA with the regulatory agencies for banks and savings and loans will serve to weaken the traditional advocacy role of the NCUA. Such previous examples have included support for a central liquidity facility, increased insurance coverage, and limited authority for federal credit unions to offer home mortgages. If credit union regulation at the federal level had been part of an omnibus federal financial regulatory agency, it is questionable as to whether the organized credit union industry would have had executive branch support for the aforementioned programs.

SUMMARY

From the state credit union regulatory perspective, we are satisfied with the current federal financial institution regulatory framework. In the credit union industry, we have not witnessed an excessive overlap between state and federal regulatory authorities. Our joint "Memorandum of Understanding" with the NCUA is working well. We feel that such a consolidation will naturally lead to excessive federal duplication of state efforts. Current NCUA staff know and understand state credit union supervisors, and this relationship will be severely altered in a consolidation.

This concludes my testimony, Mr. Chairman. I will be glad to answer any questions which you or members of the Committee may have.

NATIONAL ASSOCIATION OF STATE CREDIT UNION SUPERVISORS

MEMORANDUM OF UNDERSTANDING BETWEEN NASCUS AND NCUA

Whereas both NASCUS and NCUA are interested in continuing the viability and integrity of the credit union movement including preserving the dual-chartering system;

Whereas NASCUS through its Regulator members and NCUA have overlapping responsibility and jurisdiction over the regulation of federally insured state-chartered credit unions;

Whereas NCUA under the provisions of the National Credit Union Insurance Fund and the Federal Credit Union Act should make maximum use of state examination information in monitoring federally insured state-chartered credit unions;

Whereas NCUA has a responsible interest in the Insurance Fund and therefore in the individual credit unions which it insures;

Whereas NASCUS represents state credit union supervisors in communicating the collective concerns of its members at both the National and Regional levels of NCUA;

Whereas NASCUS has established a Governmental Relations Committee as a method to interface with NCUA in all areas of joint concern and dual responsibility;

Whereas the Regulator Members of NASCUS have primary regulatory responsibility for federally insured state-chartered credit unions and NCUA has responsibility for the integrity of the insurance fund;

Therefore the National Association of State Credit Union Supervisors and the National Credit Union Administration, in order to effect a program of uniform enforcement of various state credit union laws and the integrity of the insurance fund, do agree as follows:

(1) NASCUS and NCUA should continue their coordinated efforts on the following projects:

(a) To effect an efficient early-warning system for federally insured state-chartered credit unions.

(b) To provide special training funds and training programs for state credit union examiners.

(c) To develop uniform standardized credit union accounting procedures.

(d) To develop and/or coordinate uniform examination procedures.

(e) To develop a uniform continued insurability report form and procedures for disseminating financial data between NASCUS Regulator Members and NCUA.

(f) To develop a program and identify conditions for coordinated examinations.

(g) To establish an effective system of reporting financial data for federally insured state-chartered credit unions.

To accomplish the above, NASCUS and NCUA will meet at least semi-annually at a mutually agreed time and location. NASCUS and NCUA will designate representatives to jointly prepare appropriate agenda for each meeting.

The **CHAIRMAN**. Thank you, Mr. Carlson. Mr. Foudree.

BRUCE W. FOUDREE, COMMISSONER OF INSURANCE FOR THE STATE OF IOWA, CHAIRMAN OF THE FINANCIAL SERVICES TASK FORCE OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. **FOUDREE**. Thank you, Mr. Chairman. With me this morning is Mr. Fred Haskins, counsel to the Iowa Department.

The National Association of Insurance Commissioners appreciates this opportunity to appear before the Senate Banking Committee to present its views.

Our particular focus is, of course, the business of insurance. Even so, developments and trends in the economic environment in the past few months have prompted the NAIC to form its own task force on integrated financial services for the purpose of studying the developments following several discussions and considerations over the past several months. We, therefore, wish to address relevant issues and to provide information about the regulation of the business of insurance, which we think will be helpful to the committee, and we would like to express certain initial concerns which we have about recent and potential changes in the delivery of financial services and the regulation thereof.

THREE FUNDAMENTAL REGULATORY OBJECTIVES

There are three fundamental regulatory objectives which the NAIC and its members seek to accomplish. The first of those is to further improve the regulation of the business insurance among the United States. The second involves our primary objective, which is preserving the financial solvency of those institutions which we regulate. The third is to oversee the conduct of insurers in the marketplace including the conduct of their representatives or agents.

The NAIC has achieved these objectives both in good and bad economic times and during periods of both relatively stable and rapidly changing industry structure and product innovation.

The question of how to realize financial solvency goals when economic conditions encourage diversification and acquisitions was addressed by the NAIC during the late 1960's and early 1970's. Discussions at that time culminated in the adoption of the NAIC Model Insurance Holding Company Act.

The basic principles involved in the model law are, No. 1, a "walling off" of the assets of an insurance operation through a separate subsidiary, in order to insure policyholder protection from the potential adverse economic experience of the parent or its noninsurance affiliates.

No. 2, regulatory oversight of asset and dividend transfers between affiliates, particularly between parents and subsidiary affiliates.

No. 3, the application of normal insurance regulation oversight to the insurance subsidiary's activities.

An important point about the Holding Company Act is that financial transactions between affiliates are limited and subject to strict supervision.

It is evident that many of the generic regulatory issues concerning depository institution activities which are being studied by this committee are similar to those which have been considered and resolved for insurance companies with varying degrees of success for the last 100 years by the National Association and its members. The committee may wish to draw upon this experience.

Let me outline for you just briefly some of the concerns which we have about the integration of financial services which is occurring. Since the primary goal of the NAIC and its members is maintaining insurer solvency and supervising market conduct, to the extent that changes occur in the marketplace which will have a potential impact on the ability of the States to accomplish these two goals, the States naturally will feel the need to give such changes their attention.

The first category of concerns which I would like to outline for the committee involves the concentration of risks. This is closely related to the achievement of our primary objective, which is solvency regulation. Individually, the operations of insurers, security broker-dealers, real estate companies, banks, savings and loans and other financial institutions, experience enough hazards in operating in today's economic environment. We feel that combining under one roof the services which those institutions offer individually, brings with it risks not previously known or foreseen.

It is this concentration, to the extent it occurs, which insurance regulators look upon with considerable apprehension. Problems of regulation are compounded by such combinations and the ability of regulators to protect consumers is affected. Particular questions have been raised.

What will be the effect on bank safety and soundness of adding insurance powers, including the ability to directly underwrite?

Given the fact that the banking and the property and casualty insurance businesses are inherently cyclical, and that these cycles may coincide, what effect will variations in such cycles have on institutions which combine more than one type of service?

How should the insurance component of banks be monitored by insurance regulatory authorities, including financial examinations, capital and surplus requirements, investment practices, payment of premium taxes, and so forth? Specifically, how will their ability to commingle assets associated with credit and insurance risks and to transfer funds between accounts and affiliates affect regulatory supervision?

While the NAIC has concerns about allowing banks to engage in any insurance activities, it is particularly concerned that if insurance operations are done through a department of a bank rather than a subsidiary, the walling-off concept embodied in the Insurance Model Holding Company Act will be violated and the principles therein will not be adhered to.

SAFEGUARDS OF BANK INSURANCE POLICYHOLDERS

The absence of safeguards also raises the question of whether bank insurance policyholders should be afforded the same protection afforded to other insurance policyholders through State insurance guarantee funds. One must also consider whether under these circumstances it is appropriate for the FDIC to protect depositors for losses resulting from catastrophic bank insurance losses.

With respect to insurers seeking to engage in activities not related to insurance, the NAIC will also consider the need for modification of existing State laws, in order to insure policyholder protection. New modes of regulation or limitation on insurer activity will be explored.

The second broad category of concern which insurance regulators have involves the concentration of economic power. This really relates to the matter of fairness and consumer protection. The same combinations of products within single financial service entities bring with them the potential for an unhealthy concentration of economic power.

The unequal position of the consumer in relation to the lender and psychological subtleties cannot be ignored. There is no easy way to deal with the problem of debtor coercion.

We believe there are also a number of gaps in the Federal regulations at the present time regarding the market conduct of depository institutions or lending institutions. For example, IRA's which are marketed by deposit institutions compete directly with insurance products, but they are not subject to the same types of strict supervision of the advertising of such products as are insurers.

In conclusion, let me say that the similarities between the goals of the State insurance regulators who supervise the business of insurance and the goals and purposes underlying Federal regulation of financial institutions are readily apparent. Despite today's rapidly changing economic and technological climate, we believe that these goals and the reasons supporting them are still valid.

Proposals to permit combinations of banking and insurance activities to be performed by single entities deserve cautious and thorough analysis. A careful measuring of the possible effects of such combinations on consumers, the institutions themselves and the capacity of regulators to effectively regulate them should be done first.

Accordingly, the National Association of Insurance Commissioners supports a moratorium that would prohibit companies from acquiring any depository institution or bank, as defined in section 2(C) of the Bank Holding Company Act, which engages directly or indirectly through a subsidiary in any activity unless the activity was specifically authorized by a State statute adopted, or interpretation of a State statute promulgated, prior to January 1, 1983, or unless such activity is permissible under section 4(C)(8) of the Bank Holding Company Act.

As the committee reviews the current system for regulating financial institutions and services, to the extent that the scope of its inquiry includes insurance, we would hope the information and concerns which we have briefly raised here today will be of assistance to it.

The task force of the NAIC and the NAIC in general would be willing to meet again with the Senate Banking Committee in order to provide further information, as well as to suggest possible solutions to the problems the committee seeks to address here today.

Thank you very much.

[The complete statement follows:]

Statement of the
National Association of Insurance Commissioners

Submitted to the
Senate Committee on Banking, Housing & Urban Affairs

by
Bruce W. Foudree
Insurance Commissioner of the State of Iowa

and
Chairman of the NAIC Integrated Financial Services Task Force

May 20, 1983

The National Association of Insurance Commissioners appreciates the opportunity to comment on current issues concerning the integration of financial services and service institutions. Our particular focus is of course the business of insurance. Even so, developments and trends in the economic environment have prompted the NAIC to study the increasing integration of insurance and non-insurance activities. It was for this purpose that the NAIC formally established an Integrated Financial Services Task Force in December, 1982, following several months of consideration of various aspects of this trend by the bodies of the NAIC. We therefore wish to address relevant issues, to provide information about regulation of the business of insurance which we believe will be helpful, and to express certain initial concerns which we have about recent and potential changes in the delivery of financial services and the regulation thereof.

Insurance Regulation Today

The business of insurance is regulated by the states which, in order to further that regulation, formed the National Association of Insurance Commisioners (NAIC). The NAIC is an organization composed of the chief insurance regulators of each of the fifty states and U.S. territories. Its objective is to serve the public by assisting the several state insurance supervisory officials, individually and collectively, in achieving three fundamental insurance regulatory objectives: (1) maintenance and improvement of State regulation of insurance in a responsive and efficient manner; (2) reliability of the insurance institution as to financial solidity and guaranty against loss; and (3) fair, just and equitable treatment of policyholders and claimants. The NAIC has achieved these objectives in both good and bad economic times and during periods of both relatively stable and rapidly changing industry structure and product innovation.

In carrying out these goals, the NAIC and its members have had considerable experience dealing with (1) reconciling conflicting regulatory policies in order to make sure that competitors are placed on an equal footing; (2) making regulation more responsive to changing economic demands, technological change and consumer expectations; and (3) managing shared regulatory responsibilities among different government agencies.

The tools of solvency surveillance are constantly being honed. For example, uniform financial reporting has been achieved through a uniform annual statement developed by the NAIC and used by all insurers and accepted by all state regulators. This statement is continually reviewed in response to changing business conditions and regulatory demands. In order to eliminate the need for fifty different examinations of insurers doing business nationwide, a Zone Examination System has been developed under which a single exam of each company is conducted periodically and accepted by each regulator in the state where the company does business. The NAIC has prepared and periodically revises an Examiners Handbook which aids in maintaining and improving the quality and uniformity of examinations. The NAIC Early Warning System, designed to detect insurers in trouble, has evolved into the Insurance Regulatory Information System (IRIS) which is now far more sophisticated in its ability to discern and predict the financial condition of insurers who may require earlier or more frequent examinations.

The question of how to realize financial solvency goals when economic conditions encourage diversification and acquisitions was addressed by the NAIC during the late 1960s and early 1970s. Its deliberations culminated with the adoption of the NAIC Model Insurance Holding Company System Regulatory Act, which has now been enacted into law in forty-five states. The basic principles embodied in the model law are: (1) the "walling off" of the assets of an insurance operation through a separate subsidiary in order to assure policyholder protection from the potential adverse economic experience of the parent or its noninsurance affiliates; (2) regulatory oversight of asset and dividend transfers from the insurance operation to the parent or its affiliates; and (3) application of normal insurance regulation and oversight to the insurance subsidiary's activities. Thus, financial transactions between affiliates are limited and subject to strict supervision.

Even now, state regulators continue to engage in a dialogue with each other about the need to restructure and to amplify existing means of regulating the financial solvency of insurers. This is the highest priority of the NAIC. There is also a recognition that rapid changes in the economic environment are having an impact on the condition and behavior of insurers; changes in products and marketing methods will mean a need for adjustments in existing approaches to regulation which allow increased flexibility and effectiveness. Nevertheless, the basic goals of such regulation will remain.

It is evident that many of the generic regulatory issues concerning depository institution activities which are being studied by the Senate Banking Committee are similar to those that have been considered and resolved for insurance companies with varying degrees of success over the last 100 years by the NAIC. The Committee may wish to draw on this experience.

Concerns About the Integration of Financial Services

Since the primary regulatory goals of the members of the NAIC are maintaining insurer solvency and consumer protection, to the extent changes occur in the marketplace which have a potential impact on the ability of the states to accomplish these two goals, the states will feel a need to give such changes their attention. Consequently, legislative and commercial changes which are resulting in the integration of both financial service products and the means of their delivery have produced considerable interest and concern among state regulators. Such integration and the fading of traditional lines between banking, insurance, securities, and real estate activities may hold benefits for consumers. On the other hand, they could have serious negative effects on consumers, including insurance policyholders, and the efficacy of exisiting regulation.

In general, long standing federal law and policy and to a more limited degree state policy regarding financial institutions is being changed or affected on a piecemeal basis without sufficient thought being given to all of the ramifications of these changes. Much of this is happening not because of a conscious and deliberate decision process by legislators or regulators but rather because of rapidly changing technology and product innovations coupled with unforeseen loopholes in the existing laws. Further, it appears that some have already concluded that deregulation of financial institutions is in the public interest without a thorough understanding of the difficult public policy questions that must be answered before embarking upon such a course.

The concerns of the NAIC are graphically illustrated by the recently enacted South Dakota law that permits state-chartered banks "directly or through subsidiaries, to engage in all facets of the insurance business." 1983 S.D. Senate Bill 256, §5. It has been argued that bank holding companies can form 'non-bank' banks or acquire state chartered banks with broad powers to engage in the insurance business. If this is allowed, it would appear that the clear policy embodied in the Bank Holding Company Act will have been circumvented. A policy change of this magnitude should not occur by happenstance or because of a technical drafting oversight.

To the extent the Committee explores possible modifications of the existing federal system for regulating financial institutions and services, the NAIC would like it to keep in mind the following concerns to the degree that the Committee contemplates modifications which involve insurance products or their regulation.

Concentration of Risks; Solvency Regulation. One of the primary concerns of insurance regulators is the concentration of risks which appear to be contemplated or occurring in the financial services sector. Individually, operations of insurers, securities broker-dealers, banks, savings and loans, and real estate companies involve enough hazards and difficulties in today's environment. A growing interest in offering insurance, banking and lending, securities, and real estate services under one roof carries with it the potential combination of insurance, credit, investment, and property risks not previously known or foreseen. It is this concentration, to the extent it occurs, which insurance regulators look upon with considerable apprehension. Problems of regulation are compounded by such combinations; the ability of regulators to protect consumers is affected.

With respect to the interest of banks, 'non-bank' banks, and bank holding companies in entering into insurance activities and direct underwriting, particular questions have been raised. What will be the effect on bank safety and soundness of adding insurance powers including the ability to directly underwrite? Given the fact that the banking and the property-casualty insurance businesses are inherently cyclical, and that these cycles may coincide, what effect will variations in such cycles have on institutions which combine both businesses? How should the insurance component of banks be monitored by insurance regulatory authorities, including financial examinations, capital and surplus requirements, investment practices, payment of premium taxes, etc.? Specifically, how will their ability to comingle assets associated with credit and insurance risks and to transfer funds between accounts and affiliates affect regulatory supervision? While the

NAIC has concerns about allowing banks to engage in any insurance activities, it is particularly concerned that if insurance operations are done through a department of a bank rather than a subsidiary, the "walling-off" of assets concept embodied in the NAIC Model Holding Company Act will be violated thereby preventing effective state oversight to protect policyholders. The absence of such safeguards also raises the question of whether bank insurance policyholders should be afforded the same protection afforded to other insurance policyholders through state insurance guaranty funds. One must also consider whether under these circumstances it is appropriate for the FDIC to protect depositors for losses resulting from catastrophic bank insurance losses.

With respect to insurers seeking to engage in activities not related to insurance, the NAIC will consider the need for modification of existing state law in order to ensure policyholder protection. New modes of regulation, or limitations on insurer activity, will be explored.

Concentration of Economic Power; Fairness and Consumer Protection. The same combinations of products within single financial service entities bring with them the potential for an unhealthy concentration of economic power. Of specific concern to insurance regulators is the need to preserve fair treatment of consumers. Just how fair treatment will be assured by those who offer both banking and insurance services is a question now being asked by the states. Serious problems of tie-ins or credit leverage associated with the sale of insurance by banks have occurred in the past. Studies by the Federal Trade Commission, as well as previous violations of insurance laws, have shown that such leverage has been all too common. The potential for debtor coercion is magnified when the power to provide credit is combined with the authority to market or underwrite insurance risks. It does not require much imagination to see that credit and related services will be implicitly, if not explicitly, conditioned on the purchase of insurance. The unequal position of the consumer in relation to the lender, and the psychological subtleties which exist, cannot be ignored. There is no easy way to effectively deal with this very real problem.

An additional issue being raised is what effects will such combinations of marketing authority and power have on competition in the insurance marketplace? Will allowing banks to enter insurance activities and to directly underwrite place insurers at a competitive disadvantage with ultimate consequences for the consuming public? More specifically, will the special tax, capital and credit advantages that banks enjoy affect the ability of insurers to compete with them? Corresponding concerns could be raised about insurers seeking to directly or indirectly engage in deposit-taking activities.

Currently, the public is allowed access to information contained in financial and market conduct examination reports of insurers' operations. If banks are allowed to directly engage in the business of insurance, will such public access be required of them as well?

Also, there are gaps in federal regulations regarding the market conduct of depository institutions. For example, individual retirement accounts (IRAs) marketed by banks compete in part with annuities and other insurance products. However, insurance product advertising is subject to detailed disclosure and extensive regulation while bank advertising is not. This may explain why banks are permitted to advertise results far into the future for IRAs based on current rates while not disclosing that the current rates are subject to change. Such advertising would not be permitted under existing insurance unfair advertising principles. This type of problem will become increasingly important as new products proliferate and consumers are forced to make more difficult and complex choices regarding how to plan for their future financial security.

Considerations of fairness, coupled with the need to maintain competition between offerors of services and to facilitate the ability of consumers to make informed and independent decisions about the offerors and their products, dictate the need for equal regulatory treatment of sellers of financial services.

The foregoing comments are by no means exhaustive, but they do serve to point out some of the major NAIC concerns regarding the complex and difficult issues associated with the appropriate interrelationship between insurance and depository and other non-insurance activities.

Conclusions

The concepts and goals of insurance regulation are well-established. The goals and purposes underlying the regulation of financial institutions, their products, and their operation in the marketplace, as recognized by the Vice President's Task Group on the Regulation of Financial Services, are: (1) Assuring safety and soundness of financial institutions, and of the financial system as a whole, both to protect individual depositors and to avoid or limit secondary effects of a failed institution; (2) Avoiding conflicts of interest, fraud, and consumer abuses; (3) Promoting orderly markets to encourage savings, capital formation, and stability; and (4) Avoiding excessive concentrations of economic and financial resources. 48 Fed. Reg. 5706 (1983). The similarities between the goals of state insurance regulators, who supervise the business of insurance, and the goals and purposes underlying federal regulation of financial institutions are readily apparent. Despite today's rapidly changing economic and technological climate, we believe that these goals and the reasons supporting them are still valid. More specifically, the NAIC also believes that the traditional demarcation lines between permitted and prohibited depository institution activity were consciously and carefully based on sound public policy considerations and that the reasons for those existing regulatory policies also remain sound. This is especially so with respect to the relationship between banks and insurance companies.

Proposals to permit combinations of banking and insurance activities to be performed by single entities deserve cautious and thorough analysis. A careful measuring of the possible effects of such combinations on consumers, institutions, and the capacity and costs of regulation should be done first. Accordingly, the NAIC supports a moratorium that would prohibit companies from acquiring any depository institution or bank as defined in section 2(c) of the Bank Holding Company Act [12 U.S.C. section 1841(c)] which engages, directly or indirectly through a subsidiary, in any activity unless the activity was specifically authorized by a state statute adopted, or interpretation of a state statute promulgated, prior to January 1, 1983, or unless such activity is permissible under section 4(c)(8) of the Bank Holding Company Act [12 U.S.C. section 1843(c)(8)] for bank holding companies. This position is consistent with that taken by the Executive Committee of the NAIC on March 30, 1983, which opposes permitting the banking industry to engage in the business of insurance without adequate study of the impact on the consuming public. (A copy of that resolution is attached.)

While the Committee may ultimately conclude that modifications of current federal law are necessary, to the degree that such modifications of the federal system involve the intrusion by banks and bank holding companies into the insurance sector, the concerns expressed by state insurance regulators should be considered. The Committee might well ask whether changes which would improve competition among banks and other lending institutions and increase their ability to expand within the banking sector, such as removing restrictions on interstate branching, should be explored before those institutions are permitted to expand into the insurance sector where intense competition and excess capacity already exist.

A comprehensive insurance regulatory system is already in place and it has worked reasonably well. With the goals of insurance regulation as a guide, the members of the NAIC are constantly working to improve that system. The states through the NAIC are now studying changes occurring in the marketplace and considering modifications of existing regulation which may be needed as insurance products and institutions evolve. The NAIC Task Force on Integrated Financial Services, as well as the members of the NAIC as a whole, are committed to finding ways to accomplish the fundamental goals of insurance regulation and, consequently, to protecting the best interests of insurance consumers.

As the Committee reviews the current system for regulating financial institutions and services, to the extent that the scope of its inquiry includes insurance, we hope the information and concerns which we have briefly raised will be of assistance to it. In the event the Committee undertakes to consider possible changes in federal laws, we invite the Committee to take advantage of the expertise of the NAIC and its members. Duplicative and conflicting federal and state regulation would be unproductive and would not be in the public interest. Accordingly, the NAIC Task Force on Integrated Financial Services is willing to meet again with the Senate Banking Committee in order to provide further information as well as to offer possible solutions to problems which the Committee seeks to address. Thank you.

The following resolution was unanimously passed by the Executive Committee of the NAIC on March 30, 1983:

RESOLUTION

WHEREAS, The Federal Government enacted the Glass-Stegall Act of 1933 (or the Banking Act of 1933) to restrict the activities in which banks could engage and has continued restrictive legislation on this matter by enacting the Banking Act of 1935 and the Bank Holding Act of 1956, and

WHEREAS, On October 15, 1982 congress reaffirmed the historical separation between banking and insurance in its enactment of the Garn-St. Germain Bill of 1982 which prohibits federal banks from engaging in the activities of insurance, and

WHEREAS, The best interests of the citizens of the various states are better served by the respective state governments maintaining this prohibition against banks engaging in the business of insurance, and

WHEREAS, The unlimited financial activities of the banking industry would create enormous concentration of economic power and coercive potential inimical to consumer interests, and the best interests of the public will not be served by uncertain, unclear and contradictory regulatory standards,

NOW, THEREFORE, BE IT RESOLVED,

That the Executive Committee of the National Association of Insurance Commissioners opposes permitting the banking industry to engage in the business of insurance without adequate analysis of the potential impact on the consuming public and on appropriate regulatory mechanisms at both state and federal levels.

The **Chairman**. Thank you very much. Senator Hecht.

Senator **Hecht**. Thank you, Mr. Chairman. I think this is a very timely meeting this morning because of the different things I've been reading in the paper the last few days about the FDIC allowing certain financial institutions to engage in activities which we never felt possible.

STATES BETTER ABLE TO ASSESS NEEDS OF ITS CITIZENS

I want to ask each one of you one question to start with and then I want to ask you individual questions. Was the FDIC going into this direction to allow banks, which I have great reservations, to get into other activities? The States will take on a far greater role.

Mr. Bailey, I'll start with you. Do you feel there is any legislation that you need federally, or do you think the States can handle the situation as it is right now?

Mr. **Bailey**. I think it's beyond question; the States can handle the situation as it arises, if it arises, in individual States.

I think the extent to which it may arise in individual States will vary, and that State legislatures will be better able to assess the particular needs of the citizens of their States than probably could be addressed on a national basis by the Congress.

I think those needs do vary, I think the environment varies from State to State sufficiently to make desirable the States' presence selection.

Senator **Hecht**. One short yes or no question, which I would like to ask each of you. You favor States rights on financial institutions?

Mr. **Bailey**. State responsibility I think is a better word, Senator; yes, sir.

Senator **Hecht**. Mr. Wagner.

Mr. **Wagner**. Yes, Senator Hecht, I certainly support witness Bailey, what he has just said. States rights I think are certainly the best solution to these issues.

Senator **Hecht**. Do you feel you can handle everything at your State level?

Mr. **Wagner**. Not this session. To be honest about it, we're somewhat embryonic in a lot of these proposals because of the political, social, and economic situation in Louisiana. We have quite a few things that we're trying to do with recodification this year.

It's going to be talked about by some members of the Commerce Committee, both Senate and House, to introduce some legislation. An example is what South Dakota has done with respect to insurance, but nothing has been done in this session.

However this session ends shortly and it's too late to introduce any additional bills. They're fighting this year on statewide branching and multibank holding companies in Louisiana upon which all the attention has been focused at this time. In fact, I, myself would promote legislation issues on a States rights basis.

Senator **Hecht**. I'll come back to you with a question later on. Mr. Carlson, would you address that?

Mr. **Carlson**. Yes, I would. I think the State-chartered credit unions have shown this in that they have formed and operate and supervise 19 share guarantee corporations which offer share insurance to State-chartered banks in lieu of the Federal program.

Senator **Hecht**. Mr. Foudree.

Mr. **Foudree**. Senator, I think the changes that are occurring on both Federal and State levels have given us all reason for concern.

As far as the NAIC, though, I think we can, we will and we are attempting to respond to those changes at the State level. The NAIC is engaging in hearings of its own through a task force which I chair.

The State of New York, I was informed yesterday, through the Governor's Advisory Committee, is committed to coming up with legislative proposals by the end of this year.

I want to affirm that the States feel very strongly that they can regulate the business of insurance and are dedicated to doing so, in the spirit of the McCarran-Ferguson Act.

Senator **Hecht**. Mr. Wagner, in your testimony on page 9 you said Federal control over State-chartered entities represents an unnecessary level of regulation. I've watched this for over 20 years with State examiners and Federal going in at the same time and to basically the same purpose.

But you go on in page 10, to say that you would like to engage in securities activities. What is the average size of the savings and loans in your State of Louisiana?

Mr. **Wagner**. We're fairly small by national standards, Senator Hecht. I'd say the average institution in Louisiana is probably about $150 to $175 million in total assets.

Senator **Hecht**. Do you think a savings and loan of this size can engage in securities activities?

Mr. **Wagner**. No, sir, I do not.

Senator **Hecht**. Why are you advocating it?

Mr. **Wagner**. Of course I'm advocating it on the basis that I'm representing NASS&LS before this committee and not my individual interest as commissioner in Louisiana.

I'm really presenting it from the standpoint of other States who might have that capability.

We might have two institutions in Louisiana out of 119 that have the capability to engage in securities activities today. I don't even know that it's a profitable capability for the future. I personally don't advocate it from a Louisiana standpoint, but I think that other States, California and Texas, New York, and other State-chartered institution's have that capability, if they so elect, and I'm presenting it from the standpoint of the National Association of State Savings & Loan Supervisors.

Senator **Hecht**. But in your own State you don't advocate it?

Mr. **Wagner**. No, sir. I really do not.

DEBTOR COERCION

Senator **Hecht**. Mr. Foudree, you coined a word which with your permission I'd like to use in the future, debtor coercion. I think that's a great line.

You are very much against financial institutions engaging in the insurance industry. This has been a very hot point in the debates up to now. Elaborate that a little bit more, would you please?

Mr. **Foudree**. Yes, I would be glad to. I think the concerns center around the debtor coercion idea which I cited and the pressure which can be brought to bear on the consumer who seeks to take out a loan and who also may feel the pressure to purchase insurance through a given insurance operation; but a secondary concern relates to our goal of financial solvency regulation and the ability of banks and insurance operations when they are combined under a single roof to commingle assets, or transfer assets without proper supervision, or oversight.

Those are the two primary concerns which we have. Our goal is to make sure those institutions are around to make good on their promises to pay when the time comes.

Senator **Hecht**. Do you see any way that these different financial institutions now are seeking to do this? Do you see that they can do this profitably? Wouldn't that be a big risk to their stability and their reserves?

Mr. **Foudree**. I think that is certainly true. Combining those services under one roof could have an exponential effect on total risks.

Can they do it? There may be ways to do it safely. As a matter of fact, the financial services integration which is occurring may be beneficial to consumers in some respects. What we are concerned about is the negative impact, both on consumers and the ability of regulators to have effective oversight. We think we need to study both aspects before we charge ahead and say this is a good thing.

So the jeopardy that some insurance and banking institutions could be placed in by combining these services under one roof is certainly something we have to study, particularly in light of the inherent cyclical nature of these institutions and this business which I mentioned. The property and casualty business and some of the new products that are being offered tend to fluctuate in their loss experience. I think we would need to be careful that they do not combine in a down period with a down cycle in the lending area as well.

Senator **Hecht**. Thank you. Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Hecht. Senator Hecht referred to the FDIC's proposed rule concerning Glass-Steagall. Although I may sympathize with what they are trying to do substantively, I think they are entirely wrong in going ahead as a regulatory agency, particularly in light of the effort I made the last 2 years to look at all of these broad policy issues culminating in my bill last year; and now they have acted right in the middle of all these days of oversight hearing on Glass-Steagall.

LOOPHOLE IN GLASS-STEAGALL

The FDIC feels that they found a loophole in Glass-Steagall, and I'm sure they have. I want to state clearly here what I did in the press release as soon as I found out about it the other day, that I do not think it is really the right direction to go, for the regulators to make those kinds of decisions.

It is a legislative and a congressional decison that must be made in the context of the overall picture, not just looking at State non-member banks who may not fit in the confines of the Glass-Steagell Act.

It certainly goes far far beyond the issue that was originally in my bill last year, allowing banks to participate in municipal revenue bonds as well as managing mutual funds.

So I am opposed from that standpoint of the FDIC going ahead. I do believe that it is part of the overall issue, policy decisions that we must make in the Congress, and not just how much the FDIC wants to go ahead with deregulation.

They're only a part of this overall picture.

Senator HECHT. Mr. Chairman, could I interrupt for one moment to go on record as agreeing with you 100 percent?

I had not been on the record on that before. I think you're absolutely right and as of now, you're still been wrong only three times. [Laughter.]

The CHAIRMAN. I appreciate that. I seem to have had a hard time convincing them—as you listen to that bell, gentlemen, I'd like you to note that the country is now in danger, the Senate is in session. [Laughter.]

Let me address the issue of interstate banking. For those of you who have not appeared before the committee before, I've said many, many times that representing a small State with mostly small institutions, be they banks, savings and loans, credit unions or whatever, I do have concerns about concentrations of economic power, and that in many cases it would be nice to go back in time when everybody was neatly in their little compartments doing what they were supposed to do without all of this overlap and duplication.

FINANCIAL SERVICES INDUSTRY REVOLUTION

But that is not the real world of 1983. We are in the financial services industry revolution, whether we like it or not, not just because of the advent of money market funds and the entry of nonbank banks and Sears retailers, all sort of new services. But technology, the ability because of computers and electronic means of transferring funds, that is a revolution in and of itself.

So my question to each of you, isn't interstate banking really here? I understand the positions you are coming from, my tendency is to oppose interstate banking as I have said many, many times.

We do have grandfathered institutions in the Western United States. There's First Interstate that operates in Senator Hecht's State and my State and in nine other Western States. There's Northwest Bank Corp. of Minneapolis. We have interstate trust operations, we have interstate loan generation offices. Before Garn-St Germain was ever passed we had interstate mergers of troubled institutions.

Now we find recently in this area Safeway announced they would be putting cash machines in their stores here. So this technological change is going to occur very rapidly.

Are we fighting windmills and interstate banking is really already here? Are we putting blinders over our eyes and saying we're opposed to it, but we ought to address the issue and say what kind of policy guidelines we want to set?

It appears to me it's happening within current law. Mr. Bailey, what's your response to that?

Mr. BAILEY. I think, of course, you're absolutely right. There is now provision of banking services on a nationwide basis. EFT networks are a prime example of technological developments serving the public interest.

But there is a difference in the provision of services to those who need those services and allowing the geographic expansion of institutions which would involve the taking of deposits, the acceptance of funds in the local community. An argument can be made that the usefulness of funds should determine where they go. However, there is an obligation on the part of banks to meet the credit needs of the communities that support those banks, and I think if the barriers to the engulfment of the system by just a few large institutions were removed, those few large institutions have just that in mind.

The credit needs of Brazil, Mexico, and various and sundry other people around the world would be considered in preference to the credit needs and the need for services in the individual communities, which needs are now being met by the institutions in those communities. I think there is a need for both.

And I think a destruction of the barriers could and probably would result in the removal of those concerned with addressing the needs of the communities and regions across the country.

The CHAIRMAN. Are you advocating no changes at all? Do we keep blinders on and keep McFadden-Douglas exactly as they are, and ignore what is taking place out there? I wonder if there might not occur greater concentrations because we are not setting policy direction.

If the law doesn't fit—sort of like having a 30-mile-an-hour speed limit on the interstate. Nobody is going to abide by it. It isn't realistic. It doesn't fit the real world.

Mr. BAILEY. I think the law presently works very well. I think in those cases where there is a need for the resource that can be provided by the large, giant institutions, those resources are provided.

If, on the other hand, a giant institution is unable to remove its competition for funds in the community, the needs of the localities can be met within the present framework of the law. There is no impediment to meeting the needs of the nation, the needs of the larger institutions themselves. It seems to me the law as it is now is flexible enough to encompass all of these needs, and they have been able to be met.

I don't really see that there is a need for much fixing.

The CHAIRMAN. Let me play the devil's advocate just a little bit more. Maybe Mr. Carlson would be better able to answer this, but using California as an example, you have BankAmerica, which by anybody's standards would be considered to be a very, very large institution. California is a lot larger than many countries in this world, where they have centralized, concentrated banking systems, and I know of no State that has the diversity of financial institutions that California does.

BankAmerica, although they can go anyplace in California, does not dominate California. There are credit unions, savings and loans, and commercial banks. Is that a fair assessment, Mr. Carlson, of California, even though they have got the giant of giants in that State?

Mr. CARLSON. That's right, sir.

INTERSTATE RECIPROCITY

I might make two points here. One, in addressing this issue on a credit union basis, the State credit union system does allow interstate reciprocity, but it's a little bit different because of the common bond. In other words, the Delta Air Line credit union, or wherever it's located, does service the employees of that credit union in other States, so we already have that in place. But it's that common bond that limits the participation by the public sector in that particular credit union.

If I can put on my other hat for just a minute, I also regulate the industrial loan industry in California, which is an industry all by itself in which we have a great deal of participation by the major banks at this time. Chase Manhattan and Manufacturers and a number of those, as well as B of A, Security, and such as that. As far as California is concerned, there is room for everybody there. Everybody is on an equal footing and equal competition, and they all say the answer in everything is to invest in California real estate. [Laughter.]

We have probably as many institutions there as there are in the whole country, but there's certainly no problem created by the competition, in my State.

The CHAIRMAN. My own feeling with regard to this fear of concentration because the boundaries may be changed, regional or whatever, in the future, resulting in 12 or 15 large institutions, is that I don't believe it anymore. I don't think that will take place. I don't think there is any evidence that that would take place. We still have over 20,000 financial institutions in this country.

And another specific example, in New York State, with Citicorp. You will find most of Citicorp's successful operations are not in upstate New York. As a matter of fact, they have testified in the past that in trying to compete with the smaller institutions in upstate New York they did not do very well. They couldn't compete with the level of personal service and so on that those smaller local institutions provided.

Don't misunderstand me. I have no proposal at this point for changing McFadden. That is the purpose of going through these hearings.

But I think realistically—I do think some changes are warranted to recognize the realities of the marketplace. I really do not fear concentrations. I am turning more to worrying about concentration in the new type of financial institutions that have no restrictions, no boundaries, no reserves. My bill last year certainly has not solved that problem, at all.

Sears worries me a lot more—I shouldn't always pick on Sears, and I don't, in a negative way. They are a very fine institution, but as they expand, and Merrill Lynch and insurance companies do likewise, and banks which are now getting into the securities business—I worry more about concentrations out of the traditional depository institutions than I do about breaking down some of the barriers of McFadden.

Mr. Wagner, how do you feel? What's your feeling on McFadden and whether we have interstate banking already or not?

Mr. WAGNER. You have made some excellent points, Mr. Chairman. At the same time, I personally feel McFadden-Douglas ought to be kept intact. The reason I say that is States do have individual initiatives that they can exercise.

As an example, if Louisiana wants California banks or Texas banks or New York banks, why, we can so allow it, if the legislature deems it advisable. At this particular time, they do not. In fact, the legislature in Louisiana hasn't even deemed it advisable to branch statewide for our State-chartered institutions. Whether that's good or bad, I think, is subject to what side of the argument you are on. I personally feel it should be left intact. You have made some excellent arguments. I have heard these before, and I think you certainly are right in many respects.

The CHAIRMAN. I don't know of any new arguments on either side of the issue.

Mr. WAGNER. I have heard the same ones for some time, and I tend to agree with what you say, as an overall projection. I think future competition in financial institutions is going to be based upon the provision of a full array of financial services irrespective of geographic boundary, but I don't think I see it today. As a result, I think the States who want to address themselves to this issue can invite entry by out-of-State institutions which have that ability today.

But I think McFadden-Douglas should be kept intact, at least for the foreseeable future.

The CHAIRMAN. How do you feel about the New England experiment?

Mr. WAGNER. Again, that experiment involves States exercising their own prerogatives.

I am a member of the Southern Growth Policy Board of the Southern Governors Conference, and out of the 12 Southeastern States only Florida supports interstate operation on a regional basis for the southeastern members. Of course, this experiment was proposed by Governor Graham of Florida. The other 11 states involved did not see fit to support this. Of course, I can see what Florida is doing. They already have such penetration by out-of-State financial institutions that Governor Graham would like to create what he calls the "common market of Southeastern States," but the other States involved have not elected to participate.

The States in New England have. That's very well and good. I think it's fine, if that's the direction they want to take. But again, it's placing the issue at the feet of the State legislators, and the State legislature, and I think that is the way it ought to stay for the foreseeable future.

The CHAIRMAN. Mr. Bailey, how do you feel about the New England experiment?

Mr. BAILEY. I agree with Mr. Wagner. It's a fine example of initiative by the States to address what the State legislatures perceive as a need for their citizens, for their local economies. I have no quarrel with that whatsoever.

I think McFadden-Douglas—I have heard it compared— I don't know if it's an apt comparison or not—but I have heard the two combined and compared to the Ten Commandments, in the sense that everybody does believe in the Ten Commandments; not everybody follows all 10 of them. But that doesn't mean they ought to be repealed, by any means. They still serve a function.

I think McFadden-Douglas serves a function and unless there can be some reason shown, some need to repeal, some need to modify them, that they should not be. They have stood the test of time very well.

LIMITATIONS OF SMALLER BANKS TO COMPETE

The CHAIRMAN. I agree with both of you on the issue of States' rights. It's certainly not my place to dictate to the six New England States, if they want to get together. But, aren't you saying, that's just fine, because States are doing it, but Congress shouldn't make any changes in McFadden. Aren't your fears still the same about the arguments against changing McFadden-Douglas: concentrations, limitations on the ability of smaller banks to compete, and all of that? Is it purely a difference in States' rights that you think it's all right for the States to do this? The Northeastern part of the United States, natural market areas, and so forth, if they want to do it—but that doesn't seem to me to be too consistent with your fears about what would happen if we do break down some of the barriers of McFadden. That's changing McFadden indirectly. States do that. I am in favor of letting them do whatever they want to do. But, that is breaking down McFadden, changing it very dramatically.

Do you feel there is any inconsistency in either one of your positions?

Mr. WAGNER. I really don't feel so, Mr. Chairman. I think what we are talking about is allowing the initiative of the States to take place in these cases. If McFadden-Douglas is amended in some shape or form, then Louisiana will not have a choice—or Texas or any other State, for that matter.

I think the initiative is coming from the individual States. I don't even know if it's constitutional what they are attempting to do, so that's another issue. Can they do it on a regional basis as opposed to disallowing other States outside of that region? Again, that issue also has to be addressed.

It protects what I am doing, I think. Each individual State has the right to determine its own destiny in these cases, and by not acting with respect to existing McFadden-Douglas restrictions, it gives them that continued position, but it also gives them the right to go ahead and change if they so elect to change. I really don't see any inconsistency in that.

The CHAIRMAN. What about changing McFadden not on the basis of mergers and acquisitions? But we have had some testimony about de novo entry, changes in McFadden to allow de novo entry. The testimony has been to the effect that this would not increase concentrations, but it would increase competition.

Do any of you have positions on de novo entry? Mr. Bailey.

Mr. **Bailey**. As far as I know, McFadden does not now prohibit de novo entry from out of State. It reserves to the States the right to permit it, if it chooses. It does not prohibit—at least it doesn't strike me as being prohibitive, basically, in nature, but permissive, to the States.

If an individual State or group of States decide that de novo entry by out-of-State institutions will provide service institutions in that State are not providing, I think they can now do that, but their ability to make that choice remains.

If McFadden were substantially changed, it might be that States' ability to make that choice would be preempted, and that South Carolina would be advised to abide by rules that might be appropriate or might not be appropriate. I think the present situation is permissive.

The **Chairman**. As I listen to both of you, I really wonder. I hear the arguments I have heard for years, and I have made myself at times, about concentration.

You keep saying, well, it is all right, whatever the States want to do. So is your argument against changes in McFadden-Douglas based on concern about concentration or really protection of in-State institutions?

You see, every time I hear you answer—and again, don't misunderstand, I am trying to play the devil's advocate, to solicit testimony so we can make some decisions—I hear all the standard answers, but then as soon as I ask you about States rights, anything the States want to do is all right.

It does seem in conflict with the other argument—just because the States are doing it, it doesn't change the possibilities of these other things taking place that you fear.

Mr. **Wagner**. Well, Mr. Chairman, I think it is one and the same from the standpoint of certain States. Some States feel they can compete on a national basis much better than other smaller States.

I guess it is the individual attitude of those State legislatures as to their desires and wants in this area. Certainly, I think the de novo idea presents a better solution in the direction of change than anything before.

I think that if change does come, it will come, hopefully in that direction.

I am not totally and unalterably opposed to change in the future. I am just saying as of right now I think McFadden-Douglas is working today. I, too, am cognizant of the change.

I think it was Federal Reserve Board Chairman Volcker at a CSBS convention who stated that 90 percent of the services delivered today by the financial institutions—all types of financial institutions—90 percent of those services are delivered interstate.

So you are right, we do have interstate commerce today. EFT's are a great vehicle for interstate provision of financial services, however, the control element is key where the State can control concentration of banking or financial power by prohibiting deposit taking.

So with electronics and technology come a lot of innovation that will give regulators a better handle on services and how we can regulate in those respects.

If you have a "brick and mortar" bill in there, it is not too easy to regulate whether that institution is taking deposits when people walk in the front door. But in an electronic milieu you certainly can.

The CHAIRMAN. Senator Hecht.

Senator HECHT. I am enjoying your questioning. Keep right on going. [Laughter.]

EXTENT OF STATE CREDIT UNIONS LENDING POWERS

The CHAIRMAN. Mr. Carlson, to what extent do State credit unions have broader lending and investment powers than Federal credit unions?

Mr. CARLSON. Yes, they do, sir. That is determined on a State-by-State basis. In most cases, they are at least equal to, because the majority of States have this "wild card" provision that they would then give the State credit union the same authority that the Federal credit union would have.

The CHAIRMAN. Mr. Foudree, you said you opposed permitting the financial institutions to engage in insurance activities because the borrower would feel compelled to buy insurance from the lender.

What about finance companies that are affiliated with banks? Would you also restrict their ability to sell the insurance product?

Mr. FOUDREE. Yes. Where a finance company seeks to engage in the business of insurance, either directly through a department or indirectly through an affiliate, the same concerns would apply. The concerns which we have not only involve the subtle pressure which could be placed on the consumer, but, just as importantly, we would have a concern about the structural arrangement that would exist when you allow those institutions to combine and do business directly or indirectly in another activity. In other words, such combinations could facilitate the ability to commingle assets related to different risks. This concern involves our primary objective, and that is to preserve the solvency of insurance institutions.

The CHAIRMAN. Mr. Wagner, the Federal Banking Agency has established additional bad debt disclosure requirements for all federally insured banks, disclosure primarily pertaining to aggregate loans past due more than 90 days.

Mr. Bailey as well. Do you support this disclosure program?

Mr. WAGNER. Generally speaking, yes, Mr. Chairman, I do.

The CHAIRMAN. Mr. Bailey.

Mr. BAILEY. With some grave reservations, Mr. Chairman.

The CHAIRMAN. What public disclosures do you require for your institutions?

Mr. BAILEY. The publishing of quarterly call reports in the newspapers is of course required. The content of those call reports is effectively established by the Federal agency.

They do not include as much information as the FDIC now proposes. The usefulness of the publication of that information, I would say, escapes me.

The CHAIRMAN. You said you had some reservations about the requirements of federally insured banks by the regulators.

Could you elaborate more on what those reservations are?

Mr. BAILEY. Yes, sir.

I think information that may be disclosed will not always be published. There may be publication of only excerpts or bits and pieces. Also, I think there may be an inability on the part of at least some part of those who interpret and read that information to attach appropriate significance to it. I think the public's confidence in the banking system could be impaired as a result of this misunderstanding or misinformation.

That is a very real danger.

The CHAIRMAN. Do any of you have any additional comments that you wish to make before we close?

[No response.]

The CHAIRMAN. I would like to say to Mr. Foudree, I would compliment you on your choice of presidents. For those of you who don't know, it happens to be Mr. Roger Day, commissioner of insurance in Utah.

Senator Hecht, do you have any further comments?

Senator HECHT. No, Mr. Chairman.

The CHAIRMAN. Thank you, gentlemen. We appreciate your testimony very much.

The committee is adjourned.

[Whereupon, at 11 a.m., the committee was adjourned.]

FINANCIAL SERVICES INDUSTRY—OVERSIGHT
Part II

TUESDAY, JUNE 7, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room SD–538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn and Hecht.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Today we continue the seventh day of oversight hearings on the financial services industry.

Before we start, may I announce for the record and everyone's interest here the remainder of the schedule of hearings. Tomorrow we will hold the eighth day of oversight hearings with the Justice Department witnesses. On June 9 at 9:30 a.m. we will have financial services organizations and consumer groups. On June 14 and 15, not full hearings, but Security Subcommittee hearings, on S. 1174, the Public Utility Holding Company Act Amendments of 1983. On June 16, full committee hearings with the Comptroller General, securities regulators, and associations of realtors, homebuilders, and mortgage bankers. On June 21, the full committee hearings with former Federal regulators and the academic lights, if they can lend anything to the real world of banking. I'm trying to be careful. On June 22, we will hold full committee hearings on S. 1120 to authorize printing the back side of dollar bills which has nothing to do with these hearings. On June 27, the final day of hearings with financial industry executives is now planned on the oversight hearings at 9:30 a.m.

That does not mean we will not have more, but that will complete the initial series of 12 hearings on the subjects of Glass-Steagall, McFadden, and the Bank Holding Company Act.

Gentlemen, we are happy to have you with us this morning. Our first witness—and I understand, Mr. Patterson, you will testify on behalf of all these gentlemen—Mr. Frank Patterson, Patterson & Associates, Inc., Chevy Chase, Md.; chairman of the Federal Affairs Committee of the Independent Insurance Agents of America; Gerald K. Cassidy, Early, Cassidy & Schilling, Inc., Bethesda, Md.; past president of the National Association of Casualty & Surety Agents; Richard Nielsen, president, Johnson & Higgins of Delaware on behalf of the National Association of Insurance Brokers; and Thomas M. Gress, Topeka, Kans.; chairman, National Association of Life Underwriters Committee on Federal Law and Legislation.

Mr. Patterson.

STATEMENT OF FRANK PATTERSON, CHAIRMAN OF THE FEDERAL AFFAIRS COMMITTEE OF THE INDEPENDENT INSURANCE AGENTS OF AMERICA, ACCOMPANIED BY TOM WILSON, COUNSEL; GERALD K. CASSIDY, PAST PRESIDENT OF THE NATIONAL ASSOCIATION OF CASUALTY & SURETY AGENTS; EDWARD H. AKIN, PRESIDENT, NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS; RICHARD NIELSEN, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE BROKERS; AND THOMAS M. GREGG, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS COMMITTEE ON FEDERAL LAW AND LEGISLATION

Mr. PATTERSON. Thank you very much, Mr. Chairman. I will not repeat the introductions that you've done for us other than to say that Mr. Tom Wilson, the counsel for the Independent Insurance Agents of America, is also with us.

The CHAIRMAN. Everybody has got to have their attorney.

Mr. PATTERSON. Each of these insurance producer groups will provide the committee a more detailed description of their membership as part of their written submissions to the committee. For now I should note that together our associations represent virtually all independent property-casualty, life and health, and commercial lines brokers in the country. All of our groups, through their individual membership committees and decisionmaking boards, endorse title VI of the Garn-St Germain Act, and will continue to seek a reasonable separation between banking and insurance in the context of any reform proposal this committee may examine.

With the chairman's permission, each of our associations would like to have their written remarks made a part of the record.

The CHAIRMAN. Each of your statements will be included in the record in full.

[The complete statements of all witnesses follow:]

Oral Remarks By
MR. FRANK PATTERSON, CHAIRMAN
FEDERAL AFFAIRS COMMITTEE
Of The
INDEPENDENT INSURANCE AGENTS OF AMERICA
On Behalf Of
THE NATIONAL ASSOCIATION OF CASUALTY AND SURETY AGENTS
THE NATIONAL ASSOCIATION OF INSURANCE BROKERS
THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS
THE PROFESSIONAL INSURANCE AGENTS

Mr. Chairman, my name is Frank Patterson. I am an insurance agent from Chevy Chase, Maryland, and the Chairman of the Federal Affairs Committee of the Independent Insurance Agents of America. With me today are insurance agent representatives from four other insurance producer groups: Mr. Gerald K. Cassidy of the National Association of Casualty Surety Agents, Mr. Richard Nielsen of the National Association of Insurance Brokers, Mr. Tom Gregg of the National Association of Life Underwriters, and Mr. Edward Aikin of the Professional Insurance Agents. Also at the witness table today is Mr. Tom Wilson, Washington Counsel for IIAA.

Each of these insurance producer groups will provide the committee a more detailed description of their membership as part of their written submissions to the committee. For now I should note that together our associations represent virtually all independent property/casualty, life and health, and commercial lines brokers in the country. All of our groups, through their individual membership committees and decision-making boards, endorse Title VI of the Garn/St Germain Act, and will continue to seek a reasonable separation between banking and insurance in the context of any reform proposal this committee may examine.

With the Chairman's permission, each of our associations would like to have their written remarks made a part of the hearing record. Thank you.

Less than nine months ago this committee and Congress approved legislation that includes explicit restrictions on bank holding company insurance activities. The enactment of Title VI of the Garn/St Germain Act was deliberate, coming after many years of congressional review, court battles, and public debate. While some may not agree with the limits established by Title VI, there can be no doubt about the law's meaning and intent. Title VI is a recognition of the competitive advantages intrinsic to the control of credit and a reaffirmation of longstanding public policy that separates banking from commerce. Specifically, Title VI is intended to prohibit, with certain limited exceptions, bank holding company insurance sales and underwriting.

Yet as we speak, deliberate efforts are underway to circumvent Title VI restrictions and thwart the will of Congress and this committee as expressed last October. At the urging of several large bank holding company organizations, whose explicit purpose it is to "get around" the insurance restrictions imposed on them at the federal level, several state legislatures have enacted or are considering legislation that empowers their state-chartered banks to engage in all the insurance activities Title VI was intended to foreclose to bank holding companies.

In and of itself, the decision by state governments to establish the powers of state banks is unobjectionable--we have no quarrel with states exercising their constitutional authority to establish the ground rules by which state-chartered banks may operate within their borders. A more complicated question is raised when considering whether it is sound public policy for state banks to assume new and uncertain operating risks with the protection of taxpayer-funded FDIC insurance. But, for the most part, to the extent our state association affiliates would oppose efforts in their state legislatures to expand state bank powers to include insurance, that is a battle that must be fought and won at the state level.

What concerns us, however, and what we believe should be of great concern to this committee, is how these state laws would be used by bank holding companies unwilling to abide by the limits this committee and Congress established last year. The bank holding companies' objective is to seek enactment of expanded powers under state banking laws in order to acquire state chartered banking affiliates, and through those state bank affiliates conduct activities denied BHCs under federal law. While this may strike some as an ingenius or innovative way to beat the system, it strikes us as being contrary to federal law and the will of Congress. In the context of our federal banking system, it is not enough to look approvingly on the innovation of the marketplace or the legal ingenuity of our nation's largest banks. Congress must determine either that these changes are in the public's interest, or, if they are not, must set limits that are relevant to the day to day conduct of the banking business.

Moreover, the states that provide options for skirting the will of Congress will have done much more than simply determine their own banking structure and activities. They will have provided federal bank holding companies a platform from which to flout federal banking laws and regulations. The primacy of federal banking laws will have been turned on its head, and the individual actions of state legislatures will simply nullify one or another component of federal law or regulations. Under these circumstances, not only would Title VI and the banking holding company act be rendered meaningless, but all existing federal banking laws and regulations would be subject to state legislative repeal without the benefit of congressional review and decision.

We hope this committee agrees with us, and with statements made last month by the Secretary of the Treasury and the Chairman of the Federal Reserve Board, that this simply cannot be permitted to continue. We therefore urge the committee to pursue immediately one or more of the following courses of action designed to put a stop to the dismantling of our federal banking structure by separate state laws and regulatory fiat:

(1) A moratorium, for a specified period of time, on certain financial institution activities, state legislative initiatives, and regulatory proclamations now undermining the intended purpose of existing federal bank laws.

(2) A letter to the Federal Reserve Board asserting that state banking laws must not be used by bank holding companies to circumvent the restrictions contained in Section 4 of the BHC Act, and that to do so contradicts Title VI of the Garn/St Germain Act. In its letter, the committee should recommend that the Board explicitly foreclose any such use of state banking laws.

(3) An amendment to the BHC Act limiting the activities of state bank affiliates of bank holding companies to the non-bank activities authorized under Section 4 of the BHC Act.

Our associations will begin immediately to seek support for these proposals within the House and Senate Banking Committees and among other members of Congress. Failure to act quickly, at least to give Congress an opportunity to consider more carefully fundamental, comprehensive reform, could have long-term negative consequences for the public's financial security.

In considering comprehensive reform, we ask the committee not to overlook the elements of our banking system that historically have guided public policy. We hear a lot these days about changes in the financial services market: technological innovations, the growth and success of near bank financial service conglomerates, mergers and acquisitions, and a bewildering array of financial service hybrids all undeniably will change the way financial services are organized, marketed, and regulated. And, these changes are the catalyst for a congressional review of existing federal laws and regulations that will lead ultimately to comprehensive reform.

What we hear less about--but which is no less important--is what hasn't changed about banking. What are the features of banking and its regulation that are as valid today as they were 50 years ago? What is it beyond the call for deregulation and expanded services that we should be concerned about when considering the reconfiguration of our banking system? There are at least three fundamental features of banking we ought not abandon.

First, safety and soundness. The keystone of our banking system, safety and soundness provides both a practical and psychological underpinning for the entire banking system and is as important today as it always has been. Practically, our banking system preserves the safety and soundness of depositors' money by offering the privileges and protection of the commercial bank charter in return for careful oversight and regulation. Psychologically, the perception that one's money is safe and sound is essential to retaining the public's trust in any banking system.

Second, the separation of banking and commerce. An historic mainstay of banking, this explicit demarcation has been part of banking laws for over 100 years. Its significance is as relevant today as it was then. Commercial enterprises ought not be in the position of providing money to, or depending on lines of credit from, potential competitors--i.e. the banks in which they deposit their funds. Banks, responsible first and foremost for the safety of their depositor's money, should not be enticed into risking other people's money on competitive enterprise. They should not be put in the position of drawing on deposited funds to save themselves from the embarrassment and damage of a failed enterprise.

Third, the power of credit. With certain very recent exceptions, banks and bank holding companies today remain the predominant source of commercial credit. The power of credit uniquely and unavoidably provides banks with an unfair competitive advantage over other financial market participants, a phenomenon explicitly reflected in current banking law limits on bank entry into other enterprises.

The power of credit is the feature of the banking system particularly important to insurance agents and their customers, and the arguments on the anticompetitive effects of credit tie ins are worth re-stating. It remains a fact of life, supported by numerous academic and legislative studies, court findings, and financial and consumer regulatory agency reports, that the combination of credit and insurance (1) unfairly constricts the consumer's ability to choose the best insurance terms and service free from the influence of credit, and (2) unfairly competes against other sellers in the market who have no powers to extend or withhold credit.

Whether direct or implied, the results of the credit tie-in are the same: many consumers would purchase insurance from banks simply to protect their source of credit, not because the insurance is available at lower prices or with better product and service. And the rest of the market is fenced away by the insurmountable and unfair competitive barrier of banks' control of credit. Hence, the anomaly that bank insurance sales actually choke off competition rather than generate it. Competition never has a chance to function.

The sale of insurance is uniquely vulnerable to the abuses of credit tie ins. Unlike any of the other non-banking services now sought by banks, or already in place among a number of financial service conglomerates, only insurance is frequently required for an individual to qualify for credit. And insurance certification is almost always determined at the point of the loan transaction--a loan customer can pick and choose among a variety of other services at any time, but he must certify his insurance coverages to the loan officer.

For these and other reasons we have enumerated in previous testimony to this committee, the insurance limits established by Title VI must be retained, and the issue of credit tie ins in connection with insurance sales must be addressed in the context of any comprehensive reform proposal.

Chairman Paul Volcker of the Federal Reserve Board recently told a gathering of bankers that the traditional separation between banking and commerce "rests on concepts that concentration of economic power can be dangerous, that the potential for conflicts of interest in a service so vital as the extension of capital and credit should be minimized, and that there is a special public interest in the safety and soundness of banks." He concluded, therefore, that such separation is "fundamentally valid." That separation must be preserved--notwithstanding the temptation that might be presented by short term economic forces.

Just last week the Wall Street Journal carried a story on the continuing troubles caused by the failure earlier in the year of the United American Bank of Knoxville. We know now that as many as five other banks were forced into insolvency as the result of losses incurred in connection with bad loans at the Tennessee bank. A few weeks earlier, the foreign loan debt episode was on the front pages as Congress continued to wrestle with the financial and regulatory implications for some of our nation's largest banks of their foreign loan activities. Before that it was Seafirst, and before that Penn Square. The particular circumstances of these and other recent bank failures vary, and arguments have been made that they are somehow irrelevant to the question of deregulation and expanded powers. But surely there are common themes here worth pondering: the question of our banks' ability to perform the services and fulfill the responsibilities they are entrusted with under current law. And the example of how persistently the troubles of one part of the system come to affect the viability of other parts--even those parts that may not be formally affiliated. Surely these themes are directly, profoundly relevent to the question of whether, under the circumstances, Congress should consider entrusting banks with other, riskier authority, under less stringent regulatory oversight than now exists.

Mr. Chairman, against this backdrop we urge the committee not to overlook the policy concepts historically associated with banking, concepts that should continue to inform public policy: Safety and soundness, separation of banking from commerce, and the anti-competitive implications of the power of credit. We believe these issues will, as they should, ultimately influence the outcome of the debate now underway in Congress, the regulatory agencies, and the states. And while these first principles may influence bank deregulation in ways not entirely to the banking industry's satisfaction, they are likely to produce an outcome more clearly in the public's interest.

That concludes our oral remarks to the Committee. We'd be happy to answer any questions.

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CASUALTY & SURETY AGENTS

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GENERAL/LEGISLATIVE COUNSEL
Pierson, Ball & Dowd
Washington, D.C.

June 7, 1983

The Honorable Jake Garn
Chairman
Banking, Housing and Urban Affairs Committee
United States Senate
SD 534
Washington, D.C. 20510

Re: Senate Banking Committee's Oversight Hearing
on Financial Institution Deregulation

Dear Chairman Garn:

On behalf of the National Association of Casualty and Surety Agents (NACSA), an association representing the leading domestic, commercial property/casualty insurance agencies and brokerage firms, I am submitting for the record of the Senate Banking Committee the following written comments in response to the Oversight Hearing on Financial Institution Deregulation.

Today there are two predominant presumptions made by financial institutions. These are: 1) the commingling of all types of financial services is "inevitable" and appropriate, and 2) the consumer will be well served by large, financial conglomerates.

Drawing from these two broad presumptions are three specific predictions made by the Vice President's Task Group on Regulation of Financial Services. They are:

> First, most restrictions on prices and products offered by depository institutions will end. As a result, many if not all of the legal distinctions between the traditional categories of these institutions will disappear, although individual institutions may continue to specialize.
>
> Second, the distinctions between depository and other financial services institutions will continue to erode, as depositories increasingly enter activities traditionally limited to investment banking, brokerage and insurance firms and vice-versa.
>
> Third, depository institutions will continue to expand their geographic scope of operations through increased electronic services, expansion of subsidiary

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activities and expanded inter-state branching as a result of merger and the acquisition activity.

In summation, the Task Group apparently has already made the determination that financial conglomerates are an "inevitable" outcome and, therefore, federal regulations should be made more flexible to meet their needs.

It is NACSA's opinion, however, that the Congress needs to first ask the questions whether this trend towards large, financial conglomerates is appropriate, if it really serves the public well, and if its ultimate impact is in fact going to be pro-competitive.

NACSA is not convinced that the current trends are in the public's interest. In the long run, we do not believe the consumer or the commercial buyer will benefit, and we think the ultimate outcome will be anti-competitive, particularly for commercial enterprises in need of a variety of financial services. If current trends continue haphazardly and unregulated, NACSA foresees the following:

1) the drying up of the small-to-medium sized financial service organizations (a direct result of unfair competition);

2) a limitation on consumer and commercial buyer choice -- on the availability of products and services;

3) impersonalization and standardization of products and services; and

4) a concentration of power in a few large financial institutions and in a few geographic areas.

NACSA has observed that many federal and state legislators and regulators have too easily brushed aside the above scenario. The assumpions made by banks and the Vice President's Task Group have been made also by some members of Congress, by some in the Reagan administration and by some states; that is, that the current trend in financial services cannot be altered and that it is in the best interest of the consumer and the commercial buyer. NACSA believes strongly to the contrary and asserts that not enough thought has been given to the potential negative impact that this trend could have on fair market competition and on our overall economy. Not enough concern has been voiced by the United States Department of Treasury or by other federal bank regulators over the potential adverse effects further federal deregulation of financial institutions, the state banking reforms, and the commingling of products and services could have on small and medium sized businesses. When asked what the impact will be, most are unable to address the question. Rather, their interest seems to be to pursue deregulation of financial services, sometimes at no risks barred. NACSA questions the wisdom of proceeding in this fashion. We hope this committee will signal federal regulators and the states to proceed with caution in this area. We fear the cost to the consumer and to the small-to-medium sized businesses may be too high to proceed otherwise.

Tied directly to this is our hope that one of the primary goals of financial institution regulations continues to be to preserve the safety and soundness of our financial institutions. Also, the public interest and fair competition must always be safeguarded. Accordingly, Mr. Chairman, any comprehensive banking deregulation package must not brush aside 1) credit tie-ins, conflicts of interest, fraud and consumer abuses, and 2) excessive concentrations of economic and financial resources. These goals were laudable in the past, and we know your committee would never compromise them in the name of deregulation and financial institution reform. Title VI of the 1982 Garn-St Germain Depository Institutions Act is evidence to that fact.

NACSA believes it is not appropriate for depository institutions to provide all financial services. The strong hold that these institutions have over the depositor is unquestionable. A real danger of tie-ins between credit and other services does exist. Competition and consumer choice of price, product and service should not be put into jeopardy for the sake of "consumer" convenience.

Additionally, entering into businesses like the underwriting and the sale of insurance could put at risk the money of depositors, and the losses incurred could be passed on to consumers through higher interest rates or higher charges for other services.

Finally, the consequence of current trends for the overall structure of our economy cannot be overlooked. Envision a financial services marketplace consisting only of Citicorps, American Expresses and Bank of Americas. Categorically, NACSA believes this would be the ultimate outcome if unlimited commingling of financial services and complete deregulation of financial institutions are the result. We seriously doubt this would be in the public interest and advise this committee against the "inevitable."

Attached is a more detailed, legal analysis in support of our position as outlined in this letter and in the oral statement presented by the insurance producers' panel of today. NACSA believes a congressional moratorium is appropriate, giving Congress adequate time to resolve these complex issues and to enact legislation which will adequately protect the interests of the consumer and the commercial buyer, all of whom are in need of a variety of financial services. If NACSA can be of further assistance to you, Mr. Chairman, or to your committee and its staff, please do not hestitate to call on us.

Sincerely,

Gerald R. Cassidy

Gerald K. Cassidy
Past President
National Association of Casualty
and Surety Agents

GKC:js
Attachment

STATEMENT OF
NATIONAL ASSOCIATION OF CASUALTY & SURETY AGENTS

PRESENTED TO

SENATE COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS

Submitted by:

Gerald K. Cassidy
President
National Association of
Casualty & Surety Agents
5454 Wisconsin Avenue
Chevy Chase, Maryland 20015

LEGISLATIVE COUNSEL:

PIERSON, BALL & DOWD
1200 18th Street, N.W.
Washington, D.C. 20036

Date: June 7, 1983

I. Introduction.

Mr. Chairman and members of the Committee, my name is Cerald K. Cassidy. I am Past President of the National Association of Casualty and Surety Agents (NACSA), an organization comprising over two hundred seventy of the larger property and casualty insurance agencies and brokerage firms in the United States accounting for more than 25 percent of the total property/casualty insurance industry's premiums. NACSA appreciates the opportunity to provide for the record these written comments concerning the current status of the financial services industry and the future direction of that industry.

II. Expansion of Insurance Activities of Bank Holding Companies in 1970's.

During the decade preceding the enactment of Title VI of the Garn-St. Germain Depository Institutions Act of 1982, the Federal Reserve Board (the "Fed") had allowed bank holding companies to engage in an increasing number of insurance activities. In so doing, the Fed had improperly applied the general "closely related" standard of Section 4(c)(8) of the Bank Holding Company Act of 1956, as amended. Moreover, the Fed had also failed adequately to consider the public interest, as required by Section 4(c)(8), and to assure itself that the performance of insurance activities by bank holding companies would produce public benefits, such as increased competition or greater convenience or efficiency, that outweigh possible adverse effects such as concentration of resources, unfair competition, conflicts of interest, unsound banking practices and reduction of consumer choice. See S. Rep. No. 2879, 97th Cong., 2d Sess. 36 (1982).

Courts frequently overturned actions by the Fed, and both the courts and other federal regulatory agencies, such as the Federal Trade Commission and the staff of the Comptroller of the Currency, felt obliged to chastize the Fed for ignoring persuasive and well documented showings of anticompetitive aspects involved in permitting bank holding companies to engage in insurance activities. See, e.g., Alabama Association of Insurance Agents v. Board of Governors, 553 F.2d 224 (5th Cir. 1976), on rehearing, 558 F.2d 729 (1977), cert. denied, 435 U.S. 904 (1978); Florida Association of Insurance Agents v. Board of Governors, 591 F.2d 334 (5th Cir. 1979). During this period, insurance agents and their state and national associations, including NACSA, expended considerable effort in challenging what they considered to be improper Fed action in expanding the limits of its statutorily-conferred authority without adequately protecting against anticompetitive aspects and potential risk of loss of bank involvement in insurance.

III. Enactment of Title VI.

Applications by bank holding companies during the 1970's for Fed approval to engage in a wide range of insurance activities were simply a manifestation of a widespread effort by major commercial banks and bank holding companies to break down longstanding, congressionally sanctioned barriers separating banking and commercial activities. Because of a number of factors, including the rapid development of computer technology, inflation and high interest rates, and desire for convenience brought about by increasing social change, bank holding companies sought to compete with other participants in the financial marketplace by providing consumers with new and more "convenient" financial products and services.

One result of this expanded activity by banks was the creation of competitive inequalities, which became clear when similar if not identical products or services were offered by financial institutions that were not regulated in the same manner. In addition, the ability of bank holding companies to pressure their borrowers into unfair tie-in arrangements between the extension of credit and the purchase of insurance increased the tendency that both commercial and individual customers would have fewer options, diminished quality and higher prices in connection with the providing of many kinds of insurance products and services. As these developments took place, bank holding companies and commercial banks, the most powerful of all financial institutions, and increasingly eager to use their leverage to expand their non-banking activities, became prime movers in the federal legislative effort to achieve a so-called "level playing field."

During the course of the legislative hearings, NACSA and other representatives of the insurance industry advocated the strengthening of existing barriers to bank participation in the insurance field. NACSA argued that such restrictions would protect the consumer of insurance products and services by avoiding the potential for anticompetitive tie-in arrangements and preventing the risk of loss of depositors' federally-insured funds. Contrary to the desires of bank holding companies, however, and as a result of the better judgment of Congress, further incursion by bank holding companies into the insurance field was halted by the enactment of Title VI of the Garn-St. Germain Depository Institutions Act in October 1982. Congress explicitly stated that providing insurance as a principal, agent, or broker is not "closely related to banking or managing or controlling banks," except within the limits of certain narrow exceptions, and clearly resolved the federal legislative debate over bank involvement in the insurance field.

IV. Recent Developments Could Undermine Congressional Action.

Despite the clear expression of Congressional intent embodied in Title VI, the bank holding companies, led by the largest, Citicorp, have embarked on a campaign to circumvent the clear intent of Congress by taking advantage of a loophole alleged to exist in the Title VI prohibition. Relying on the premise that the Title VI prohibition applies only to their non-banking subsidiaries and not to subsidiary state-chartered banks, Citicorp successfully lobbied the South Dakota legislature to amend its banking law to expressly authorize state-chartered South Dakota banks to engage in "all facets of the insurance business." With the laws so amended, Citicorp agreed to purchase a state-chartered bank in South Dakota with the intent of engaging in various insurance activities outside of the state. Similar bills to expand the permissible insurance and other commercial activities of state banks have been introduced or enacted in the legislatures of Delaware, Illinois, Maine and Minnesota, and it is logical to expect that more will be introduced in other states unless Congress takes immediate action to prevent further evasion of federal banking laws and regulations.

The actions taken by the South Dakota legislature would permit a federally-regulated bank holding company such as Citicorp to engage in the sale or underwriting of insurance products through a subsidiary state-chartered bank, even though a non-banking subsidiary is clearly prohibited from engaging in such activities under Title VI. Although it is probable that Congress intended the prohibition to apply regardless of the character of the subsidiary, the South Dakota case raises the immediate question of how the Congress and federal regulators should deal with such blatant attempts to escape the clearly intended restrictions of federal law. It also raises, in a concrete framework, the larger question of the future relationship between federal and state banking regulatory schemes, particularly as support grows for removing the restrictions against interstate banking activities.

Traditionally, the two regulatory frameworks have co-existed, although state-chartered banks have generally been subject to regulation that is not inconsistent with federal regulation. Some regulators, such as Treasury Secretary Donald T. Regan, argue that a uniform system of federal regulation of banking is the better approach in the current and future financial environment, while others argue that the states should have the opportunity to allow banking institutions to experiment in the marketplace under looser restraints of progressive state laws, which can usually be enacted more expeditiously than federal laws. The states are then looked upon as testing grounds, and past experience shows that, if successful, new regulatory principles have often been adopted by other states or by the Congress.

In NACSA's view, there is a significant difference between experimenting with new legal guidelines in the face of Congressional inaction, and amending state laws to allow activities subject to clear expressions of Congressional disapproval. Clearly, the South Dakota legislative action falls into the second category. In any event, it is certain that unless action is taken quickly to provide for a thorough examination of these issues, the indiscriminate and imprudent use of state laws to accelerate change or circumvent federal restrictions will continue unabated.

NACSA believes that federal bank regulators should be especially concerned by the South Dakota experiment. Although Citicorp's agreement is to purchase a state-chartered bank regulated by state law, there is a substantial federal interest involved in the proposed arrangement: the potential exposure of federal taxpayer funds which are set aside for federal bank deposit insurance to the greater risks of non-banking, commercial activities. Because most state-chartered banks are insured by the Federal Deposit Insurance Corporation (FDIC), those funds may be called upon to cover losses incurred as a result of the bank's insurance activities. This is a danger that NACSA has cited repeatedly in opposition to proposals by banks and bank regulators to allow banks to engage in various areas of the insurance business. To avoid this risk potential, it may be appropriate and necessary to condition the coverage provided by federal deposit insurance on adherence to federal banking restrictions.

Not to be outdone by Citicorp, some non-banking institutions have shone a different light on the question of the use of state laws and federal deposit insurance in the present environment of rapid change and frequently proposed mergers of different forms of financial institutions. In situations in which a brokerage firm, for example, acquires a federally-insured, state-chartered bank, the federal regulators other than FDIC apparently are not involved, particularly if the state bank's activities are restructured in such a way as to put the insitution outside the traditional definition of "bank" under the federal Bank Holding Company Act. The simple transfiguration of a bank into a so-called "non-bank bank" demonstrates that the increasing blending of activities and institutions in the financial services industry, if not examined promptly, may allow institutions arbitrarily to select a favorable regulator, and may further blur the definitional and jurisdictional boundaries, which until recently were thought to be identifiable. Under the pressure built up by rapid change and experimentation, it appears that significant cracks in the federal banking regulatory framework are in serious need of repair.

V. Proposals.

NACSA urges this Committee immediately to adopt the following measures to halt the haphazard expansionary actions of financial institutions and to dampen the current disposition of many state legislatures to accommodate the desires of large financial institutions that promise jobs and other economic advantages and openly contravene federal restrictions:

(A) Moratorium.

Congress should impose a moratorium, for a reasonable period of time, on certain financial institution activities, state legislative initiatives, and regulatory proclamations now undermining the intended purpose of existing bank laws.

Although the Garn-St. Germain Act of 1982 clarified many issues in connection with the regulation of the financial services industry in the 1980's, many issues remain clouded and unresolved. Furthermore, it is clear that the bank holding companies and other financial institutions will go on testing the limits of existing restrictions on their activities and will continue to search for available loopholes to circumvent those restrictions. The confusion and instability generated by the flurry of actions of bank holding companies in the present competitive marketplace is evidenced by the expressions of concern by many state and federal regulators, as well as by the disagreements among them on many of the important issues.

Chairman Volcker has recently voiced his concern over the proposed legislation in Delaware that would allow state banks to underwrite and sell insurance, stating in a letter to the Delaware Insurance Commissioner that he is

> seriously concerned about the possibility of widely divergent and inconsistent laws governing both bank and thrift powers, with deposit-taking organizations shopping for the most permissive rules, and states competing to pass such laws in order to enhance local employment.

Secretary Regan has also expressed his view to this Committee that state legislative amendments should be overruled, and that a moratorium should be imposed to prevent financial institutions from using newly amended state laws to acquire state-chartered banks and engage in insurance activities.

The National Association of Insurance Commissioners, at a recent meeting at which the South Dakota legislation was discussed, have expressed their opposition to the involvement of the banking industry in insurance activities, and stated that "the best interests of the public will not be served by uncertain, unclear and contradictory regulatory standards" pertaining to banking and insurance. In addition, as you are aware, the Comptroller of the Currency recently imposed a moratorium to preclude non-banking institutions from establishing "non-bank banks," which accept deposits but make no commercial loans.

In light of all these recent developments since the enactment of the Garn-St. Germain Act, NACSA believes that it is extremely important for the Congress, federal and state regulators, and members of the various branches of the financial services industry to support immediate stop-gap measures. Implementation of a moratorium would prevent the sort of unchangeable "fait accompli" which would result from too many mergers and acquisitions of banks and non-banks, and for which Chairman Volcker has expressed serious concern. With a moratorium in place, however, all interested parties would be in a position to step back and focus on the current condition of the industry in a freezed frame, rather than to attempt an examination of an ever-evolving environment.

(B) Committee Statement of Legislative Intent.

The Committee should deliver a letter to the Federal Reserve Board (in a form similar to the letter attached hereto as Appendix A) asserting that the use of state banking laws by bank holding companies to circumvent the restrictions contained in Section 4(c)(8) of the Bank Holding Company Act contradicts what the committee approved last year in connection with Title VI of the Garn-St. Germain Act. It is NACSA's view that under the provisions of Title VI the Congress has authorized the Fed to impose restraints on bank holding companies that would preclude them from resorting to state banking laws as authority for achieving indirectly what is directly prohibited under Section 4(c)(8) of the Act. In its letter, therefore, the committee should recommend that the Fed explicitly foreclose any such use of state banking laws.

(C) Technical Amendments To Close Loopholes.

The Congress should approve an amendment to Section 3 of the Bank Holding Company Act (in the form attached hereto as Appendix B) that would limit the activities of state bank affiliates of bank holding companies to the non-bank activities authorized under Section 4(c)(8) of the Bank Holding Company Act.

Conclusion.

NACSA believes that the Committee should undertake to implement the proposals set forth above in order to ensure specifically that the prohibitions set forth in Title VI are not nullified by reliance on inconsistent state laws. Furthermore, these proposals will afford all interested parties valuable time to pause to consider the proper regulatory action to be taken to accommodate the need for beneficial changes in the financial services industry, but more importantly, to protect the interests of consumers of products and services in such a rapidly changing environment.

APPENDIX A

[Letterhead of the Senate Banking Committee]

The Honorable Paul A. Volcker
Chairman
Board of Governors of the Federal
Reserve System
20th and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Chairman Volcker:

South Dakota has enacted legislation that authorizes South Dakota banks to engage in "all facets of the insurance business." Delaware may soon be asked to approve legislation that would permit Delaware banks to engage not only in unlimited insurance activities, but also in unrestricted securities and real estate activities as well. The Wall Street Journal recently reported that as many as a dozen states are considering similar legislation.

During your April 26, 1983 appearance before the Senate Banking Committee, you expressed concern that state-law initiatives such as those undertaken in South Dakota and elsewhere might allow state-chartered banks to engage in a much wider range of non-financial activities than would be permissible under the Bank Holding Company Act ("BHC Act"). You also testified that the Federal Reserve Board in the past has accorded a limited amount of deference to state laws that would authorize state-chartered banks to undertake activities that would technically not be permissible under federal law. In light of the legislative initiatives occurring in a number of states, however, you stated that the Board's policy toward nonbanking activities of holding company state-bank affiliates needs to be reviewed.

As recently as last October, this Committee and Congress, after long and careful deliberation, approved certain explicit restrictions on bank holding company insurance activities. Those restrictions were set out in Title VI of the Garn-St Germain Act. The state-law initiatives that are currently underway are inconsistent with the nonbanking restrictions of the BHC Act generally, and directly at odds with the insurance limitation imposed so recently by Congress through Title VI of the Garn-St Germain Act.

Given the tenor of current law, the Board appears to possess ample statutory authority to prevent the circumvention of the nonbanking restrictions of the BHC Act through state-bank components of bank holding companies. We therefore urge the Board promptly to declare that the nonbanking restrictions of the BHC Act may not be circumvented through holding company state-bank affiliates. Such a declaration by the Board should help forestall the enactment of additional permissive state laws, and will permit Congress to continue consideration of the proper relationship between banking and nonbanking activities in the unpressured climate that you have suggested is necessary.

We look forward to receiving from you a prompt response to these suggestions. Also, we would be happy to receive any other information the Board may have on this very important subject.

Very truly yours,

APPENDIX B

BANK HOLDING COMPANY ACT OF 1956

Amendment to Prevent Circumvention of Non-Banking Restrictions Through Banking Subsidiaries

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Section 3 of the Bank Holding Company Act of 1956 (12 U.S.C. §1842) is hereby amended by adding to that Section a new Subsection (f) to read as follows:

Prohibitions

(f) "No bank that is a bank holding company and no bank that is a subsidiary of a bank holding company may directly or indirectly engage in any activity that is prohibited under Section 4 of this Act."

BANK HOLDING COMPANY ACT OF 1956

Amendment to Prevent Circumvention of Nonbanking Restrictions Through State Bank Subsidiaries

Section 4(a) of the Bank Holding Company Act of 1956 (the "Act") (12 U.S.C. § 1843(a)) prohibits bank holding companies from acquiring "direct or indirect ownership or control of any voting shares of any company which is not a bank." The purpose of that prohibition has always been to keep banking separated from commerce -- a separation that has existed in our banking laws since the advent of the national banking system in 1864.

Section 4(c) of the Act (12 U.S.C. § 1843(c)) enumerates the situations in which the general prohibition against the combination of banking and nonbanking activities does not apply. Principal among those exceptions is the exception that permits bank holding companies to engage in activities that are "closely related" to banking in such a way as to be in the public interest. As recently as October 15, 1982, Title VI of the Garn-St Germain Depository Institutions Act of 1982, Pub. L. 97-320, amended that exception by expressly prohibiting bank holding companies from engaging as underwriter, agent or broker in any but a very few situations.

On March 4, 1983, South Dakota enacted legislation that expressly authorizes South Dakota banks to engage in "all facets of the insurance business." Citicorp recently announced its intention to acquire a South Dakota bank for the purpose of entering into a nationwide insurance agency and underwriting operation. The apparent theory behind Citicorp's initiative is that the nonbanking restrictions set forth in the Act do not apply to activities conducted by bank holding companies through state-bank subsidiaries.

In effect, Citicorp proposes to circumvent the insurance restrictions so recently imposed on bank holding companies by Congress by declaring that, since its enactment in 1956, the Act has been an incipient nullity -- a comprehensive scheme of bank holding company regulation waiting to be dismantled by the actions of a single state. The plain language, legislative history, and judicial construction of the Act all belie the premise which apparently motivated the enactment of the South Dakota law. Nevertheless, since it is vital that the banking industry be subject to centralized regulation at the federal level, and since doubts have been expressed about the validity of the Act in the face of more liberal state banking laws, it is appropriate to amend the Act expressly to state that its nonbanking restrictions apply not only to bank holding companies and their nonbanking subsidiaries, but also to each and every banking component of the holding company system as well.

The accompanying legislation would amend Section 3 of the Act by adding to it a new subsection which expressly states that no bank that is a bank holding company or a subsidiary of a bank holding company may directly or indirectly engage in any activity that is prohibited under Section 4 of the Act.

Statement by

Edward H. Akin, CPCU
President

J. Knox Hillman, Jr., FMS
Chairman, Federal/State
Affairs Committee

of the National Association of

PROFESSIONAL INSURANCE AGENTS

The following statement is submitted to the Senate Committee on Banking, Housing, and Urban Affairs by the National Association of Professional Insurance Agents (PIA).

PIA is a national trade association representing more than 40,000 independent property and casualty insurance agents in all 50 States, the District of Columbia, Puerto Rico and the U.S. Virgin Islands.

PIA has long been concerned about the continuing efforts of bank holding companies (BHCs) and other depository institutions to get further involved in the business of insurance. We have closely followed this issue since the 91st Congress and have voiced our opposition to BHCs and the savings and loan industry underwriting and selling insurance to House and Senate Banking Committees whenever an opportunity presented itself. PIA welcomes the Committee's invitation to present our views at these oversight hearings on the changes taking place in the financial services industry and to participate in the insurance producers (agents and brokers) witness panel.

The general thrust of federal banking legislation since the early days of the Great Depression has involved Congressional efforts to protect the general public and the banking industry itself from unsound banking practices. This policy has been developed in the Glass-Steagall Act of 1933, the Banking Act of 1935, the Bank Holding Company Act of 1956 (BHC Act), the Bank Holding Company Act Amendments of 1970 and the regulatory structure that these laws implemented. The main approach to accomplish the two goals of protecting the public and the soundness of banks has been careful regulation of banking activities, and restrictions upon the commercial activities in which banking organizations may engage. Indeed, the separation of banking and commerce has developed over the years into a sound public policy that has served this nation well.

It is obvious that the competitive pressures now being exerted on regulated depository institutions by the money market funds, financial services conglomerates and, recently, the so-called non-bank banks, to cite a few examples, have been intense. These unregulated financial entities often provide many bank-type services, in addition to totally new creative financial services. They function with few or none of the legal restrictions covering regulated institutions. This rapidly changing situation has caused the entire issue of the degree to which banking and commerce should be separated to again come before the Congress, as these oversight hearings have already so amply illustrated.

Federally regulated banking institutions want the current legal restrictions on their economic activities removed so that they can compete, service for service, with the likes of Sears or Merrill Lynch.

As previously mentioned, PIA has been seriously concerned about keeping the general commercial activities of the insurance industry separate from the business of banking, long before the major changes, some would say 'revolution,' in financial services began in earnest. PIA has been engaged since 1968 in a campaign to persuade the Congress that consumer choice and open competition in insurance sales required the enactment of legislation to impose restrictions on the insurance activities of federally chartered BHCs. Over the years, we have joined forces with other trade associations to accomplish this goal.

This collective effort finally culminated in the enactment of Title VI of the Garn-St Germain Act of 1982. This placed clear and concise limitations on the property and casualty and life insurance activities of BHCs and their subsidiaries. Title VI's language and the accompanying Committee Report leave no doubt about Congressional policy.

Title VI is a reasonable approach. It is fair to the BHCs, fair to the insurance industry, and, above all, fair to the consumer. It provides six exemptions to the general BHC insurance prohibition:

1. BHCs already engaging in, or that had applied for authorization for, insurance activities as of May 1, 1982, were grandfathered as to those activities.

2. Specific exemptions were also provided to allow BHCs to act as underwriters, agents or brokers with respect to credit life, credit disability and involuntary unemployment insurance which insures the repayment of outstanding loan balances.

3. Finance companies that are subsidiaries of BHCs would be allowed to sell property insurance on collateral for loans up to $10,000 or $25,000 for loans to purchase mobile homes.

4. BHCs and their subsidiaries can also engage in general insurance agency activities in towns having a population of less than 5,000 or where the BHC, after notice and opportunity for hearing, can demonstrate that inadequate insurance agency facilities exist.

5. BHCs are authorized to supervise the activities of agents selling fidelity and property and casualty insurance to the BHC itself or its subsidiaries and group insurance that protects the employees of the BHC or its subsidiaries.

6. BHCs havings assets of $50 million or less (around 2,800 BHCs) can engage in all insurance agency activities without regard to Title VI's general prohibitions.

Title VI grants a selected number of insurance activities which BHCs contend are necessary to protect the security of their loans. PIA will live with these exceptions.

The independent insurance agent is protected because Title VI generally prohibits a BHC from providing insurance as underwriter, agent or broker, subject to the six exceptions noted above. This prevents BHCs from imposing unfair competition on independent agents and insurers by explicitly or implicitly tying the sale of insurance to extensions of credit.

The major impact of Title VI is consumer protection. Without this provision, a BHC's lending bank need only inform potential borrowers that its parent BHC also has insurance for sale and the tie-in has been made. Anyone seeking credit would logically conclude that purchasing their insurance from the lending BHC may indeed enhance their probabilities of having their loan application approved. Purchasing future insurance needs from the BHC would help them should they later need additional credit. Within this context, getting that loan approved becomes the all-important thing even though the borrower probably could have obtained identical insurance coverage at a lower premium with better follow-up service if he had shopped around in the highly competitive independent insurance market. Title VI precludes such implied tying of general life and property and casualty insurance sales to a BHC's extensions of credit. In this area the consumer maintains his freedom of choice in his insurance purchasing decisions. PIA believes this free and open insurance competition is beneficial to everyone concerned.

With Title VI the law of the land, PIA became very alarmed to learn early in February that Citicorp, one of the nations largest BHCs, was aggressively lobbying the Governors and General Assemblies in Delaware and South Dakota to obtain the enactment of far reaching amendments to to the banking and insurance laws of these states. Citicorp's proposal would allow an out-of-state BHC (Citicorp) to acquire a bank chartered by the state. Said state-chartered bank would be authorized to sell and/or underwrite insurance on an extra-territorial basis. Citicorp promoted this proposal on the premise that South Dakota and Delaware could enact such laws because the BHC Act allows the several states to regulate the activities of state-chartered banks under their control and that the BHC Act did not cover the activities of such banks. Citicorp also sold this approach as a jobs and economic development bill that would greatly benefit these states if they got in on the ground floor.

In South Dakota, the Governor snapped at Citicorp's bait immediately and the General Assembly soon fell into line. In April, they enacted a law allowing state-chartered banks to engage in "all aspects of the insurance business," to be owned by out-of-state BHCs and engage in the insurance business in all states with a limiting exception in South Dakota.

Citicorp's efforts in Delaware have not been so successful. So much intrastate opposition has developed that the proposal's progress has been greatly retarded. As of this date, the Citicorp proposal has not been formally introduced in the General Assembly. The current draft would allow Delaware-chartered banks to engage in all aspects of the insurance business and be owned by out-of-state BHCs (Citicorp).

The opponents of this legislation were helped by the timely circulation among legislators of a letter to the Insurance Commission of Delaware from the Chairman of the Board of Governors of the Federal Reserve System, objecting to this turn of events. (See Attachment A.)

Citicorp's efforts can only be labeled as a blatant attempt to make an end-run of doubtful legality around the insurance prohibitions in Section 4(c)(8) of the BHC Act as amended by Title VI.

This South Dakota law, its Delaware counterpart and similar efforts in other states raise some _very_ serious national public policy issues that extend far beyond their adverse impact upon the insurance industry and consumers. Should the South Dakota approach go unchallenged and prevail, it will mean that the legislatures, urged on by powerful BHCs, can enact laws at their whim which will eviscerate the Bank Holding Company Act and leave this preemptive federal law and the wise public policy that it establishes as nothing more than a paper shell, devoid of enforceable legal substance. PIA would like to believe that this Committee and the Congress, in its wisdom, will not abandon the field and allow this to happen.

On April 6, this Committee held oversight hearings. The Secretary of the Treasury, the Honorable Donald T. Regan, testified about the broad series of fundamental changes now taking place in the financial services industry. While PIA does not agree with the portions of his testimony regarding the Administration's proposed Bank Holding Company Deregulation Act, the Secretary nonetheless raised some important philosophical points that bear repeating. They dealt with the South Dakota/ Citicorp situation. He clearly indicated that financial services provided by federally chartered BHCs and their subsidiaries should be under federal control. He expressed concern about the South Dakota law and its concept of competition by legislative laxity where each state tries to regulate less, in an effort to lure BHCs to base operations in their jurisdiction. He quite properly raised the issue of who would, as a practical matter, regulate the insurance aspects in South Dakota: The state banking commissioner? The state insurance regulators? Both state authorities? Or possibly effective regulation by neither, due to the turf conflicts involved?

Regan stressed that the Federal Reserve System (Fed) should have the authority to regulate BHCs and their affiliate activities so that all such entities play by the same federal rules. What is important about Secretary Regan's testimony is the idea that the states cannot be allowed to embark on financial services deregulation schemes on a helter-skelter basis because an essential national interest is involved. Some authority has to be in control when a federally-chartered BHC is involved and that authority must be the Fed. PIA supports this proposition.

On April 26, the Chairman of the Board of Governors of the Federal Reserve System, the Honorable Paul A. Volker, testified and elaborated on the aforecited issues raised by Secretary Regan. Chairman Volker pointed out that states are providing sweeping authority to their banks that goes far beyond the authority of federal banking entities and stressed that both the Fed and Congress should carefully review these situations. He suggested that legislation would provide the best remedy because it sets clear public policy. He also recommended that the South Dakota situation should be included in moratorium legislation to put the financial services revolution on hold for a sufficient time period so that the Senate and House Banking Committees and the Congress can work their will on these complex issues in an orderly deliberative manner. PIA agrees with him on the need for a moratorium, and action by the Fed, and a federal legislative remedy.

Mr. Volker also questioned the merits of allowing BHCs to sell insurance because his experience showed that when one part of a BHC gets into financial trouble, the other part also tends to get into trouble. He did not believe that setting up a BHC subsidiary can really insulate one from the other. PIA believes that Chairman Volker is most perceptive.

We can only add to his observations by pointing out that insurance, by its very nature, is a highly technical and risky commercial venture, subject to severe fluctuating profit and loss underwriting cycles. Currently, the insurance industry is still experiencing the bottom side of an unusually prolonged underwriting loss cycle. We do not believe that the potential soundness of the banks in a holding company should be jeopardized by speculative investment in the vagaries of the insurance market. This is especially true, in light of recent bank failures.

The rapid changes taking place in the financial services industry and the creative legal approaches being utilized by innovative sectors thereof to get around restrictions in federal banking laws that would otherwise thwart their efforts are not limited to the credit/insurance tie-in issue. For example, there are groups that have been creating the so-called "non-banks banks." A non-bank bank is, for practical purposes, a bank functioning as a bank except that it does not make commercial loans. By not engaging in commercial lending activities, non-bank banks avoid federal regulation because a federally-chartered commercial bank is defined as an entity taking "demand deposits" and making "commercial loans." This approach had broad potential to allow a number of banking institutions to operate outside of the federal regulatory structure. It has been temporarily curtailed by a regulatory moratorium imposed by the Comptroller of the Currency.

There is also a serious issue about the use of Federal Deposit Insurance Corporation (FDIC) insurance in South Dakota type situations. Under current law, all banks affiliated with a federally chartered BHC must participate in the FDIC program. Assume that the South Dakota chartered bank, that will be the insurance subsidiary of Citicorp, gets into serious financial troubles resulting from its insurance operations. Should the FDIC be there to render assistance when their losses stem from commercial insurance activities? PIA believes that the FDIC should be only insuring commercial banks. The FDIC should not be involved with entities that are in reality insurance companies with a nationwide marketing scope and banks in name only.

This entire situation is getting out of hand in a manner that will threaten the safety and soundness of regulated depository institutions and the financial services system generally. This Committee must carefully examine these developing concentrations of financial resources and related conflicts of interest in the provision of financial services. The natural unguided development of financial services must be brought to a halt so that the Congress can work its will on these admittedly controversial issues in a reasoned and thorough manner.

PIA, therefore, respectfully recommends the following course of action for the Committee's consideration:

1. A statutory moratorium should be enacted for a reasonable time frame, covering financial

institution initiatives designed to render ineffective the federal banking laws and related regulatory structures. PIA is a part of an insurance coalition that has been negotiating with the Fed to develop acceptable moratorium language. A moratorim proposal, acceptable to PIA, is attached for the Committee's consideration. (See Attachment B.)

The enactment of a moratorium would provide an interim period where all financial services interests could come before the Banking Committees to state their positions on the direction the Congress should pursue to restore the financial services marketplace.

2. PIA recommends that a letter should be sent to the Federal Reserve Board concerning the South Dakota situation. This letter, signed by the leadership of the Senate and House Banking Committees, would urge the Fed to exercise its regulatory authority to disapprove the use of state banking laws to avoid the restrictions contained in Section 4 of the BHC Act, as amended by Title VI. A copy of suggested text for said letter is enclosed. (See Attachment C.)

A prompt communication to the Fed would be especially timely since Citicorp has already formally petitioned the Fed to obtain approval for acquisition of the American State Bank of Rapid City, South Dakota. Subject to Fed approval, American State will become the insurance subsidiary of Citicorp. PIA strongly urges Senators Garn and Proxmire to sign this letter as soon as possible and to urge their House Banking Committee counterparts to join them.

3. PIA strongly believes that there should also be an amendment to the BHC Act that would specifically preclude South Dakota-type efforts to directly or indirectly get around the BHC restrictions contained in Section 4 of the BHC Act as amended by Title VI. A copy of this proposed amendment is attached. (See Attachment D.) This amendment would solve our BHC problem by closing any potential loopholes.

PIA will actively join insurance coalition lobbying efforts to obtain Senate and House Banking Committee support for acceptable moratorium legislation, the letter to the Fed, and the BHC Act Amendment previously mentioned.

We sincerely thank the Committee for providing us with this opportunity to present the positions of the National Association of Professional Insurance Agents on the structure of the financial services industry. Should the Committee need any additional information in this regard, we would be pleased to promptly provide it.

* * *

Attachment A

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

APR 14

April 12, 1983

Mr. David H. Elliott
Insurance Commissioner
State of Delaware Department
of Insurance
21 The Green
Dover, Delaware 19901

Dear Mr. Elliott:

Thank you for your letter of March 17, 1983, regarding the draft legislation expanding the powers of banks and trust companies now pending in the Delaware state legislature. The proposal would permit Delaware chartered banks to engage in insurance underwriting and sales, as well as in various other financial services at present prohibited for national banks and holding companies. These include real estate brokerage, corporate security underwriting, operation of a mutual fund, the sale of travel services, and a number of corollary activities.

As you may know, a number of states are considering -- or have enacted -- laws providing for an expansion of the powers of banks and thrift institutions beyond those permitted under federal law. I am seriously concerned about the possibility of widely divergent and inconsistent laws governing both bank and thrift powers, with deposit-taking organizations shopping for the most permissive rules, and states competing to pass such laws in order to enhance local employment. The Secretary of the Treasury has stated that "this kind of deregulation -- haphazard and without consistency or an underlying concept of what is appropriate for an insured institution -- is obviously unsatisfactory," and I agree with him fully. In such a process the public interest may well be lost in assuring that the structure of banking legislation appropriately reflects continuing concern about the safety and soundness of our depository institutions and the appropriate borderline between banking and other activities.

The possibility of 50 different and competing banking laws authorizing banking throughout the United States raises major questions of national policy which deserve the most serious and fundamental consideration. Our dual banking system has remained strong and viable in a framework in which there were no massive conflicts between the powers provided by the different chartering authorities. Federal law regulating bank holding companies sets, in effect, broad parameters for institutions operating across state lines. States are free to legislate in those areas where diversity would be desirable to meet the local requirements, but the implication has been that a single state, or group of states, should not set the nationwide pattern. This approach would seem to be basically impaired if states enact laws designed to authorize banking institutions to conduct their activities in all other states. This would be particularly true where the authorizing law places major impediments on the state-chartered bank doing business in the chartering state and encourages that institution to do business in the remaining 49 states.

Moreover, the Federal Government has a strong interest in these aspects of regulation and supervision since federal agencies -- the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, and the Federal Reserve -- ultimately will have to deal with any adverse consequences for the liquidity and viability of banks or thrifts of expanded powers and with effects on monetary policy.

As you know, many of the issues regarding the banking powers are also under review at the federal level by the Administration, the Congress, and the regulatory agencies. I do not know what this process will bring -- at the Federal Reserve we have not yet formulated final positions on many of these matters, including insurance activities of banks. In the context of the dual banking system, a degree of state experimentation and flexibility has been useful. However, wholesale and radical reconstruction of banking laws with national import prior to Congressional action on these matters seems to me unfortunate, raising major questions of national policy on which hasty action would be highly undesirable. Consequently, I would urge the states to await the outcome of federal consideration of these issues.

Sincerely,

Paul A Volcker

Attachment B

Fed Draft 5/24/83

A Bill

SEC. 101. Section 2(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)) is amended by adding the following sentences at the end thereof:

"Provided, however, that for the purposes of section 3(a) of this Act, the term "bank" shall also include any institution organized under the laws of the jurisdictions listed above, other than an institution expressly exempted under this subsection, that (1) is an insured bank as defined in 12 U.S.C. 1813, or is eligible to become an insured bank under 12 U.S.C. 1815, or (2) accepts deposits that the depositor may withdraw by check or similar means for payment to third parties and engages in the business of making commercial loans. No company that acquires or has acquired control of a bank as defined in the foregoing proviso between May __, 1983, [date of introduction of bill] and April 30, 1984, may engage, directly or indirectly, including through a subsidiary, in any activity other than an activity authorized under section 4 of this act. This proviso shall not apply to any acquisition occurring after April 30, 1984.

SEC. 102. Section 408 of the National Housing Act (12 U.S.C. 1730a) is amended by adding at the end thereof the following new subsection:

"(o) Notwithstanding any other provision of this section, except subsection (m) of this section, the Corporation shall not, between the date of enactment of this subsection and

April 30, 1984, approve any application to acquire control of an insured institution by any company engaged, directly or indirectly, including through a subsidiary (except an insured institution), in any activity other than an activity authorized as of January 1, 1983, under subsection (c)(2) of this section (12 U.S.C. 1730a(c)(2)), or under section 4 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843). No company that acquires control of an insured institution between May__, 1983, [the date of introduction of this bill] and the date of enactment of this subsection, except under subsection (m) of this section, may engage in any activity, directly or indirectly, including through a subsidiary (except an insured institution), other than an activity described in the preceding sentence."

Sec. 103. Section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828) is amended by adding the following new subsection at the end thereof:

(m) "No state-chartered depository institution (as that term is defined in 12 U.S.C. § 461(b)) may, between May --, 1983 (date of introduction of bill) and April 30, 1984, commence, either directly or indirectly, including through a subsidiary, any activity not previously and lawfully engaged in by that institution unless (i) such activity was authorized explicitly and not by implication by a state statute adopted, or by interpretation promulgated thereunder, prior to January 1, 1983; (ii) such activity is permissible under section 4(c)(8) of the Bank Holding Company Act (12 U.S.C. 1843(c)(8)); or (iii) such activity is explicitly authorized by a state statute, or interpretation promulgated thereunder, and is performed exclusively in the state authorizing such activity for customers in that state; provided, however, that this subsection does not authorize the conduct of any activity currently prohibited to state-chartered depository institutions under Sec. 16, 20 or 21 of the Glass-Steagall Act (12 U.S.C. 24, 377 & 378a.). Any state-chartered depository institution that commenced, directly or indirectly, including through a subsidiary, between May __, 1983, [the date of introduction of this bill] and the date of enactment of this subsection, an activity that would be prohibited by this subsection if commenced after enactment of this subsection shall, upon enactment of this subsection, terminate such activity."

Sec. 104. Nothing in this Act is intended to express Congressional approval or disapproval for any activity performed by a depository institution or a depository institution holding company or to reflect any intent by Congress to authorize the continuation of such activity."

Attachment C

[Letterhead of the Senate Banking Committee]

The Honorable Paul A. Volcker
Chairman
Board of Governors of the Federal
Reserve System
20th and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Chairman Volcker:

South Dakota has enacted legislation that authorizes South Dakota banks to engage in "all facets of the insurance business." Delaware may soon be asked to approve legislation that would permit Delaware banks to engage not only in unlimited insurance activities, but also in unrestricted securities and real estate activities as well. The Wall Street Journal recently reported that as many as a dozen states are considering similar legislation.

During your April 26, 1983 appearance before the Senate Banking Committee, you expressed concern that state-law initiatives such as those undertaken in South Dakota and elsewhere might allow state-chartered banks to engage in a much wider range of non-financial activities than would be permissible under the Bank Holding Company Act ("BHC Act"). You also testified that the Federal Reserve Board in the past has accorded a limited amount of deference to state laws that would authorize state-chartered banks to undertake activities that would technically not be permissible under federal law. In light of the legislative initiatives occurring in a number of states, however, you stated that the Board's policy toward nonbanking activities of holding company state-bank affiliates needs to be reviewed.

As recently as last October, this Committee and Congress, after long and careful deliberation, approved certain explicit restrictions on bank holding company insurance activities. Those restrictions were set out in Title VI of the Garn-St Germain Act. The state-law initiatives that are currently underway are inconsistent with the nonbanking restrictions of the BHC Act generally, and directly at odds with the insurance limitation imposed so recently by Congress through Title VI of the Garn-St Germain Act.

Given the tenor of current law, the Board appears to possess ample statutory authority to prevent the circumvention of the nonbanking restrictions of the BHC Act through state-bank components of bank holding companies. We therefore urge the Board promptly to declare that the nonbanking restrictions of the BHC Act may not be circumvented through holding company state-bank affiliates. Such a declaration by the Board should help forestall the enactment of additional permissive state laws, and will permit Congress to continue consideration of the proper relationship between banking and nonbanking activities in the unpressured climate that you have suggested is necessary.

We look forward to receiving from you a prompt response to these suggestions. Also, we would be happy to receive any other information the Board may have on this very important subject.

Very truly yours,

Attachment D

BANK HOLDING COMPANY ACT OF 1956

Amendment to Prevent Circumvention of Non-Banking Restrictions Through Banking Subsidiaries

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Section 3 of the Bank Holding Company Act of 1956 (12 U.S.C. §1842) is hereby amended by adding to that Section a new Subsection (f) to read as follows:

Prohibitions

(f) "No bank that is a bank holding company and no bank that is a subsidiary of a bank holding company may directly or indirectly engage in any activity that is prohibited under Section 4 of this Act."

NATIONAL ASSOCIATION OF INSURANCE BROKERS
311 First Street N.W. • Suite 700 • Washington, D.C. 20001 • Telephone (202)783-8880

June 3, 1983

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
U.S. Senate
Washington, D.C. 20510

Re: June 7, 1983, Oversight Hearing on
Domestic Financial Services Industry

Dear Mr. Chairman:

Historically, the National Association of Insurance Brokers (NAIB) has remained neutral in the debate on financial services deregulation, including the question of whether banks should have expanded insurance distribution and underwriting authority. This position was built on NAIB's support for open competition in the delivery of insurance products and services.

The NAIB represents major commercial insurance brokers with offices throughout the United States and around the world. Our members sell and service the majority of the nation's business-related insurance coverages. It is the primary function and responsibility of a commercial insurance broker to develop insurance programs and provide related products and services to protect the assets of clients.

Insurance brokers on occasion work with the commercial banking community in arranging risk financing programs for clients. Bankers also are beginning to compete directly with insurance brokers in the sale and service of unbundled risk management services.

In this context, NAIB member firms continue to believe that competitive innovations, including new methods of distributing financial insurance products and services, benefit clients. Our member firms are part of a highly competitive industry that welcomes fair competition. NAIB recognizes, however, that lending institutions enjoy a decided and potentially unfair advantage, because individual and corporate consumers will link the purchase of financial products, including insurance, to the extension of credit.

Even when financial institutions take no action that would tie credit to the purchase of insurance products and services, lenders have an intangible leverage that is inherent in any credit transaction. There is ample evidence that individual consumers, when confronted with a question about purchase of insurance at the time they are receiving credit, often assume that purchase of the insurance is part of the lending package.

The lenders' intangible leverage could be present in transactions with more sophisticated buyers, especially commercial customers, even though lenders don't attempt to coerce their customers. The fact that a tie in is illegal is irrelevant in the business context, because savvy businesses may assume that their relationship with a lending institution will be strengthened if they purchase insurance products and services along with credit. Furthermore, it is virtually impossible to legislate against this intangible leverage, this tie in, from happening in practice.

It is also important to note that insurance is unique among financial products distributed by lending institutions in that insurance requirements typically are an inherent part of the loan transaction. Evidence of insurance often must be established before credit commitments are fulfilled.

Therefore, on March 3, 1983, the NAIB board of directors voted to express its support for Title VI of the Depository Institutions Act of 1982 (P.L. 97-320), which restricts the distribution and underwriting of insurance by bank holding companies.

The board also affirmed NAIB's support of state regulation of insurance. NAIB is opposed to financial services deregulation proposals that would lead to federal regulation of the insurance industry and changes in state laws that would enable lending institutions to circumvent the intent of federal law. We see, for example, that the banking community is pushing vigorously to enact new state laws to circumvent the Congressional intent of Title VI restricting the distribution and underwriting of insurance by bank holding companies.

As we have noted, one of the most significant problems posed by the entry of lending institutions into the insurance brokerage business is the unfair competitive advantage due to the potential tie in between extension of credit and purchase of insurance products and services which cannot be legislated out of existence. This unfair competitive advantage is compounded by the fact that lending institutions have access to privileged financial information of their customers.

As the principal representative of the client in the insurance marketplace, brokers are concerned that insurance consumers not be placed at a competitive disadvantage by being coerced through intangible leverage into buying insurance services from one source, such as a lending institution. This is particularly true in situations where lending institutions may have side-stepped existing regulatory requirements, accumulated weak or improperly secured loan portfolios, or placed their depositors and their clients at undue risk through mismanagement.

Whether it is intangible leverage or direct tie in that leads consumers to a lending institution for insurance products and services, it is the consumer who will be poorly served if banks are allowed to ignore federal law and enter the insurance business. We believe the existence of a competitive financial services marketplace for insurance where consumers can make free choices has served our nation well. The system which separates banking from the insurance industry continues to work for the benefit of insurance buyers.

We appreciate your consideration of NAIB's views and would be happy to provide additional information at your request.

Sincerely,

Walter T. Derk
President

William S. Jennings

William S. Jennings
Chairman, Financial Services
Subcommittee

NALU The National Association of Life Underwriters
1922 F STREET, N.W., WASHINGTON, D.C. 20006 • 202 / 331-6000

Mr. Chairman and members of the Committee, I am Thomas M. Gregg, a life underwriter from Topeka, Kansas and Chairman of The National Association of Life Underwriters ("NALU") Federal Law and Legislation Committee. NALU is a national trade association whose members are more than 1,000 state and local life underwriter associations representing over 125,000 life and health insurance agents, general agents and managers throughout the country.

I am pleased to have this opportunity to present NALU's views on the condition of the domestic financial services industry and on the competitive implications of further deregulation of depository institutions.

By the passage of Title VI of P.L.97-320, the Garn-St Germain Depository Institutions Act of 1982, Congress reaffirmed the long-standing public policy first enunciated in the National Banking Act of 1864 that has separated banking from commerce. Agents' organizations have been working toward enactment of restrictive legislation of this kind ever since the Bank Holding Company Act was amended to allow bank holding companies to engage in nonbanking activities that are so "closely related" to banking as to be a proper incident thereto.

The Garn-St Germain legislation alleviated many of the concerns of members of The National Association of Life Underwriters who agreed that, as enacted, the legislation really did reflect insurance activities that were either truly related to banking or were otherwise justified, while at the same time the legislation fairly precluded bank-insurance activities that life insurance agents believed to be overly permissive. According to the conference report, the legislation "established that the sale of insurance does not, except for activities subject to the exceptions [in the bill], meet the 'closely related' test of Section 4(c)(8) of the Bank Holding Company Act."

NALU believes that passage of Title VI was a victory for consumers and will help to preserve an open, competitive marketplace by preventing bank holding companies and their subsidiaries from using their power to grant (or withhold) credit to pressure the consumer to purchase insurance. While not always explicit, the pressure to purchase insurance (the subtle tie-in sale) may be a mere perception of the buyer that it would be to his advantage to make the joint purchases. Title VI will allow consumers to purchase insurance which has the best terms, quality and services, not due to a need to obtain, or a fear of losing, a line of credit.

Title VI covered the insurance activities of non-bank subsidiaries of bank holding companies, and there seemed to be no reason to look for insurance activities on the part of _bank_ subsidiaries of bank holding companies.

However, on March 4, 1983, less than six months after passage of Title VI of P.L.97-320, now-famous banking legislation was signed into law in South Dakota by Governor William Janklow. It was offered to the Legislature as an "emergency act." This state law seems designed to circumvent Section 4 of the Banking Holding Company Act, as amended by Title VI of the Garn-St Germain bill.

The South Dakota law now in effect generally empowers a South Dakota state bank to engage, directly or through subsidiaries, in all facets of the insurance business. This legislation permits out-of-state bank holding companies to acquire a single new South Dakota state bank and a single existing state bank, either of which may apparently engage in all facets of the insurance business.

It is unclear at this time whether the Federal Reserve Board can and will permit a bank holding company to underwrite and sell all kinds of insurance by purchasing a state bank in South Dakota, which in turn is also (or becomes) an insurance company. It is clear, however, that the new South Dakota law is predicated upon just such an event being attempted. And, in fact, Citicorp has taken steps to acquire a South Dakota-chartered bank with the well-publicized intention of entering the insurance business.

If Citicorp is successful in its attempt to purchase a

South Dakota bank, which then is ultimately permitted to also underwrite and sell insurance, then Citicorp may well seek to combine its loan origination offices presently existing in many markets with an insurance marketing apparatus. State insurance laws and state insurance departments will be a factor in determining the ultimate extent of Citicorp's (or other bank holding company's) insurance marketing scheme. According to the June 6 edition of Businessweek, First Interstate Bancorp has purchased Big Stone State Bank in Big Stone, South Dakota, and Security Pacific Bancorp has indicated that it will open a South Dakota subsidiary as well.

To justify emergency enactment, the legislature of South Dakota cited as reasons "...steadily rising unemployment, low farm prices, a continuing drought and other adverse economic conditions," saying that "...the people of South Dakota are in need of additional employment opportunities..." The preamble to the bill continued: "For an uncertain, brief period of time, national laws allow South Dakota a unique opportunity to secure needed tax revenue and jobs...An immediate need exists for South Dakota to be the first state to pass this bank powers legislation. If another state is first in enacting such legislation, South Dakota would not collect the needed use, sales, franchise and other tax revenues from any companies who choose to locate in the other state."

South Dakota does not stand alone in the consideration of more permissive bank legislation. It is expected that similar legislation will soon be introduced in the Delaware legislature, and indeed many states may follow suit.

NALU deplores the deliberate attempt by bank holding companies to circumvent the Bank Holding Company Act by engaging in activities through state banking subsidiaries which are prohibited to bank holding companies and their non-banking subsidiaries. The Citicorp effort in South Dakota to purchase a South Dakota bank for the purpose of offering nationwide insurance services is contrary both to the purposes of the Bank Holding Company Act and inconsistent with the Congressional intent of Title VI of the Garn-St Germain Depository Institutions Act of 1982.

Therefore, NALU, in association with the other insurance producer groups on this panel, urges this Committee to approve the proposed amendment to the Bank Holding Company Act attached to this statement. Our proposal sets forth that a bank holding company cannot circumvent Bank Holding Company Act restrictions on non-bank activities authorized under Section 4 by acquiring or converting a state-chartered bank subsidiary which has been defined by state law to be able to engage in activities prohibited by Section 4 of the BHC Act.

In addition to the anti-competitive implications of the South Dakota law, it and similar pending legislation could theoretically nullify all federal regulation of banking. In recent testimony before this committee, Treasury Secretary Regan spoke to this point and criticized the South Dakota law and similar measures then pending in other state legislatures because of their adverse impact on federal regulation of banking. Regan also characterized the South Dakota approach as leading to a "competition among the states to see who can regulate the least." He urged Congress to "take over and regulate in this area...so that you don't get six or seven or eight or ten states changing their law rapidly in order to try to get some advantage over other states in this area."

The Secretary also endorsed a moratorium imposed last April by the Comptroller of the Currency on the further chartering of so-called "non-bank" banks. Secretary Regan recommended that Congress expand the Comptroller's moratorium to include the regulatory jurisdictions of all other banking regulators in order to maintain the status quo so that Congress can decide whether the public interest will be served by further deregulation.

Federal Reserve Board Chairman Paul A. Volcker concurred with Secretary Regan in recommending that Congress adopt legislation placing into effect a moratorium of limited duration on the expansion into the banking and thrift industry by non-depository institutions. Such a moratorium would also temporarily preclude state action that broadens the permissible activities of state-chartered banks and thrifts, as in South Dakota.

Chairman Volcker also criticized the new South Dakota law. He said the motivation, in large part, appeared to be a desire to compete for jobs among states, rather than careful consideration of the desirable evolution of the financial structure for the nation. While the Federal Reserve Board has in the past allowed state-chartered banks affiliated with a bank holding company to engage in any activity permitted under state law for the bank, Volcker stated, "In view of current developments, I believe that policy should be reviewed to consider whether the result is to undercut the federal standards set forth in the Bank Holding Company Act, particularly when the wider powers might clearly be exercised largely beyond the borders of the state providing the authority."

Furthermore, last April Chairman Volcker urged that state insurance regulators "await the outcome of federal consideration of these issues." He said he is "seriously concerned about the possibility of widely divergent and inconsistent laws governing both bank and thrift powers, with deposit-taking organizations shopping for the most permissive rules, and states competing to pass such laws in order to enhance local employment."

Accordingly, NALU urges this committee to approve legislation putting into effect a moratorium on the expansion into the banking and thrift industry by non-depository institutions and to prohibit state-chartered institutions from engaging in activities unless the activity is permissible under Section 4 of the Bank Holding Company Act. Congress, not the regulators nor private industry, must ultimately decide to what extent further deregulation serves the public interest. A moratorium will permit Congress to chart the future course of our financial institutions before it is a fait accompli.

While NALU cannot predict what Congress may ultimately allow financial markets to look like in the future, we do have a general philosophy that shapes our opinion on how financial markets should be structured and regulated. NALU adheres to the principle that insurance products should not be sold by depository institutions which engage in commercial or consumer lending activities. Our concern is founded on the dangers such arrangements portend in the way of decreased and unfair competition, conflicts of interest, and undue or unlawful tying arrangements. NALU's arguments to this effect have been presented many times over the years before this committee.

Basically, NALU believes that institutions which extend credit to the general public are ominously positioned in the financial sector of the economy because of the tremendous power inherent in the credit-granting process. Through this truly awesome power to grant (or withhold) credit, a bank and its affiliates are in a position to exert unfair influence (even though this admittedly may occur unintentionally) over a would-be credit customer in cases where a decision is to be made on whether to purchase additional or related services or products from the bank or its affiliates, or from an independent source.

A Federal Reserve Board staff study of tie-ins between extensions of credit and sales of insurance found that about 36 percent of all customers purchasing credit life insurance felt that the purchase of this insurance was either strongly recommended or required. [See materials collected in hearing, Tie-Ins of the Sale of Insurance by Banks and Bank Holding Companies, U.S. Senate Committee on Banking, 96th Cong., 1st Sess. (June 14, 1979)]

This statistic, together with a Federal Trade Commission report that "penetration rates" for credit life insurance sales to customers by finance companies are in the 90 percent range [letter from FTC Bureau of Consumer Protection to Senator Proxmire (March 9, 1979)], prompts NALU to believe that persuasive evidence exists that lenders should, in most instances, be affirmatively precluded from marketing insurance to their customers.

NALU's basic concerns with the expansion of bank holding companies into non-banking activities was expressed in a 1969 report of a survey conducted by the House Committee on Banking and Currency. It listed three major adverse consequences resulting from the mixing of banking and non-banking activities within the same corporate structure. NALU believes these findings are just as pertinent in the present context:

> "(1) There is inevitably a strong temptation to have the banking subsidiary of a holding company extend large amounts of credit, perhaps unwisely, to other holding company subsidiaries, thus creating unsound financial conditions for the bank to the detriment of the bank's depositors, stockholders and the public at large. This is the kind of activity in which some of the larger banks in the country were engaged in the 1920's.
>
> "(2) Since banks are the principal suppliers of substantial credit to almost every industrial, commercial and other kind of business in the United States, banks should not be in a position to discriminate unfairly against these users of bank credit by establishing competing subsidiaries and then denying credit to the competitors of the bank's non-banking subsidiaries. This is a particularly serious problem in the many cities and towns all over the United States where there are only one or two major banking institutions to which business can turn for substantial amounts of credit.
>
> "(3) Because many large and small businesses, as well as individuals, depend on bank credit for their economic existence, bank subsidiaries of one-bank holding companies are in a position to insist or 'strongly insist' that if the borrower wants continued access to bank credit, it should also use the services of the holding company's other subsidiaries. These services might include insurance, equipment leasing, property management, accounting, computing, investment and travel services, or any other business the holding company might decide to undertake. This would create unfair competition for non-bank related competitors of these subsidiaries and could in the long run substantially reduce or eliminate competition in many businesses to the detriment of the public interest." [Staff of House Committee on Banking and Currency, 91st Cong., 1st Sess., Report on the growth of unregistered

bank holding companies. (Comm. Print 1969)]

While instances of blatant coercion have been documented in past hearings before this and the House Banking Committee, a practice known as "voluntary tying" is more likely to arise when banking institutions are permitted to enter fields not directly related to banking. Drawing on the historical record again, a good description of the dangers of voluntary tie-ins was provided by Assistant Attorney General Richard McLaren during the hearings on the 1970 Bank Holding Company Act Amendments. In his testimony, Mr. McLaren referred to a situation,

> "(W)here a potential borrower may independently decide that, just because he might possibly be under watch, it is in his best interest to patronize bank-affiliated enterprises in the hope of improving his chances of obtaining credit from the bank on favorable terms, or indeed at all.
>
> "This can be illustrated by an example. A potential loan applicant might voluntarily place his casualty insurance business with a bank-affiliated insurer in hopes of improving his chances for a mortgage loan on the insured property on favorable terms. This would have the same effect as a coercive tie-in. Competition in the tied product, insurance, would be lessened to the extent that customers no longer purchased it entirely on its own economic merit. One such merger might well trigger others and, as a pattern of such bank insurance affiliations developed, market foreclosure in the tied field would become more and more serious.
>
> "Such voluntary tying or tying effect, as we called it in a recent case, is the product of market structure--not misconduct.
>
> "This structural problem is intensified because present antitrust remedies appear inadequate to deal directly with it. There simply is no illegal practice or conduct for a court to enjoin. Hence, we must concentrate on avoiding a structure which gives rise to such effects." [Hearings on Bank Holding Company Act amendments before the Senate Committee on Banking and

Currency, 91st Cong., 1st Sess. (1969)]

Once again, we think Mr. McLaren's points are just as valid today as they were in 1969.

In sports there are visibly level playing fields on which competitions of all kinds are regularly carried on. And such Elysian fields may also be found for competition within the respective worlds of business and of banking. Life insurance field people question whether level fields can even be bulldozed into playing condition where the competitors are to come from the traditionally separate spheres of business and banking.

A freely competitive marketplace cannot occur when the Federal Government insures banks' deposits and where banks are not permitted to fail. It is arguably impossible to have a level playing field with a bank. Where banks are in the game, insurance agents will always have to battle uphill against the credit-granting leverage banks naturally have over customers that can cause them, albeit indirectly and only by inference, to purchase other bank-affiliated products and services, including insurance.

As for insurance consumers, the National Association of Insurance Commissioners has recently told this committee that, "It does not require much imagination to see that credit and related services will be implicitly, if not explicitly, conditioned on the purchase of insurance. The unequal position of the consumer in relation to the lender and the psychological subtleties which exist cannot be ignored. There is no easy way to effectively deal with this very real problem."

As for business competitors of bank affiliates, the bank is in a position to withhold or refuse to grant credit. Banks are also positioned to compete unfairly against competitors of the bank's non-banking enterprises by virtue of their possession of confidential information about bank customers.

To illustrate this point through a case which has recently come to our attention, a national bank in Michigan recently informed its customers that it had retained a life insurance consulting firm to review the life insurance used as collateral for loans. To cite another example, a life underwriter in Virginia recently received a joint letter from his bank and an insurance company that he could purchase a group mortgage accidental death insurance plan. Enclosed was a separate notice from the bank and a card showing his mortgage balance and the monthly premium for the insurance.

The life underwriter objected to the disclosure of his mortgage to the insurance company. He also indicated that he would not generally recommend an accidental death policy to his clients as it gives most persons a false sense of security since they cannot envision themselves dying of natural causes, but can accidentally. However, should they die in the near future of natural causes, they would not be covered.

Banking and business have traditionally been maintained separate and apart. Our hope would be that the present reexamination of the financial services industry would result in enhancement and definition of these lines of demarcation, rather than in their further obscurity.

To the extent that the field cannot be leveled, we would argue that federal and state umpires should not permit the game to be played.

Therefore, in summary, we believe that Congress should:

(1) Adopt the attached legislation to prevent bank holding companies from attempting to circumvent Bank Holding Company Act non-bank restrictions through state-chartered bank subsidiaries.

(2) Approve a moratorium on the expansion into the banking and thrift industry by non-depository institutions and to prohibit state-chartered institutions from engaging in activities unless the activity is permissible under Section 4 of the Bank Holding Act.

BANK HOLDING COMPANY ACT OF 1956

Amendment to Prevent Circumvention of Nonbanking Restrictions Through Banking Subsidiaries

Section 3 of the Bank Holding Company Act of 1956 (12 U.S.C. Section 1842) is hereby amended by adding to that Section a new Subsection (f) to read as follows:

> "(f) No bank that is a holding company and no bank that is a subsidiary of such a holding company may directly or indirectly engage in any activity that is prohibited under Section 4 of this Act."

The CHAIRMAN. Thank you, Mr. Patterson.

NONBANKING INSTITUTIONS GETTING INTO THE BANKING BUSINESS

You make a very persuasive case for proceeding cautiously. There's no doubt that Congress will. These things do take time. But there is, as you caution, we continue to separate banking and commerce and I don't know anyone who is talking about not keeping that fundamental separation, but there is no mention of the other side of the coin that has propelled this whole debate over the last 3 or 4 years—nonbanking type institutions getting into the banking business.

While everybody is saying keep the banking business out of everybody else's business, Prudential is getting involved in insurance—I mean—I hope they've been involved in insurance—in the securities business and I don't need to go through the whole litany of Sears and American Express and all of the institutions who have traditionally been in other types of business who think it's just fine to get in the savings and loan and banking business.

So your testimony, in my opinion, is persuasive, as I say, to be careful of what we let the banks do, but what about the other side? What are you going to do? Just tell the banks, OK, everybody sit back and relax; don't do anything; we're going to keep the traditional restrictions on you while everybody else rips off pieces of your business. How do you control the other side?

Mr. PATTERSON. I don't want to monopolize this. Would anybody else want to tackle that one?

As we have previously said, Mr. Chairman, we have not really viewed I don't think the conglomerates in quite the same way as we do the banks because their power to extend credit exceeds the financial power of most of the conglomerates as we know them today.

We feel we can compete with them. We have been competing with them. But again, that ability to extend credit, whether it be to the purchaser of a home or whether it be to the owner of a contracting business who needs a $2 million line of credit, that in this point of time is not available through these financial conglomerates, and I think there's a vast difference.

We have a specific problem to address and that certainly is what we are addressing.

The CHAIRMAN. Sears is not becoming a financial conglomerate with the ability to extend loans, credit, and so on?

Mr. PATTERSON. Certainly if they can extend it in exactly the same that the banks currently do it, it is.

The CHAIRMAN. My experience in the insurance business is that those that are extending $2 million loans certainly didn't compete with the business I had in the insurance business. I wasn't involved in that size. We're basically talking about the home mortgages and the consumer credit things of that that are in competition with most of the independent insurance agents of this country?

Mr. PATTERSON. I think what we're talking about goes far beyond that. As I just mentioned, we're talking about the situation of a homebuilder or a builder of large buildings, a general contractor who needs a very substantial line of credit from a bank, the bank's ability to extend that line of credit maybe perhaps for a larger amount of money or on better terms certainly is in a very, very favorable position to control that contractor's business.

In this instance, we aren't talking about just simply a homeowner or a fire policy. We're talking about hundreds of thousands of dollars' worth of premiums and we would not even be able to compete fairly in that sort of environment because it goes way beyond it.

Mr. **Akin**. Mr. Chairman, I think the point is that we're against tie-in sales no matter where they come from. We don't want the insurance agents to have the ability to make tie-in sales either, any more than we want the bank holding companies to have that ability.

Mr. **Gregg**. Mr. Chairman, may I add a comment, please?

The **Chairman**. Certainly.

Mr. **Gregg**. Actually, speaking to the insurance companies who appear to be interested in getting into the banking business, I think they are following a procedure that any of us would follow at this time were we prudent businessmen. They don't know which way the ball is going to go or how it's going to float. The dike was created by Congress and somehow a leak has sprung and as long as the leak exists I think they're positioning themselves to be competitive if the leak gets bigger and insurers can indeed get into the banking business.

Mr. **Nielsen**. Mr. Chairman, could I add something to that? Oftentimes, it's said that we're afraid of competition, but I don't think that's true at all. I don't think there's any industry in this country which I'm aware of that is more competitive than ours, either from the company standpoint or from the agency standpoint.

There are thousands of agents and brokers and thousands of insurance companies competing every single day for business.

FEAR OF UNFAIR COMPETITION

What we are afraid of is unfair competition. Personally, I don't care whether General Motors and Exxon go into the insurance business. I couldn't care less. We would compete all day with them. But when a bank goes into the insurance business as an agency or as an underwriter, I think they have an unfair advantage. I'm doubtful that a tie-in sale can be legislated against. Yes, you can make tie-in sales illegal, but the inherent and subtle leverage that exists means you can't legislate against it.

So I would submit to the committee that banks are a different animal. They do have an advantage not available to others in the industry.

The **Chairman**. Well, you're all missing the point I'm trying to extract from you. I understand what you're saying. I understand unfair competition. I understand tie-ins. And I think you're all aware that title VI is in the bill because I kept it there with great pressure, because everybody said, "Hey, you're going the opposite direction—everything else is deregulation and this is reregulation." So that's a fact of life.

My point is, though, when you talk about unfairness, there's unfairness on the other side. That's why we have money market accounts for banks because Merrill Lynch and others have them, and that was unfair competition. Now you can't come to this committee and ask for fair competition on one side of the coin and not the other, and allow Prudential to buy banks and savings and loans and insurance companies to go the other direction. I realize you're representing the agents, not the companies, but nevertheless, the insurance business continues to try and get in everybody else's business but then says, "Hey, hold it, don't get into ours." That's the point I'm trying to draw out of you and maybe you can't answer it. Maybe the companies need to answer that.

Mr. GREGG. Maybe they should, Mr. Chairman, but in the process of doing that, if the playing field was indeed level and includes Prudential, then we will abide by that as an agent association. My own particular association represents 125,000 independent small businessmen and the other folks at this table represent another 125,000 independent small businessmen, and we are speaking for them. And if the playing field is indeed level and the rules are the same for all concerned, then Prudential will not be in the banking business.

Mr. AKIN. Mr. Chairman, our reason for suggesting the moratorium is because it certainly seems obvious to us that when title VI passed last year, the Congress did not foresee the situation that has developed in South Dakota may also occur in Delaware. We wanted to establish the moratorium so that we could answer some of the questions that you have about who is going to supply the financial services in this country in the future.

The CHAIRMAN. I hesitate to go to a moratorium and the reason I do is it's been my experience in the 9 years that I've been on this committee, as many of you have heard me say, that Congress is very good at emergency pieces of legislation and moratoriums and extensions for 90 days of this and that and whatever. It's been very poor at making policy decision. The major reason I'm against the moratorium—it sounds very attractive in the short run. Moratoriums tend to get extended over and over and over again and it's a way for Congress to cop out and simply not face making the tough decisions that are difficult politically to make in many cases.

There is no doubt that the Garn-St Germain Act would never have passed had we not had a crisis in the savings and loan industry. Congress was finally forced to act on some policy changes and structural changes that should have been made years ago before I ever got here, simply because we were facing massive failures in the S&L's.

I was faced with a great deal of pressure in December of 1981 to simply go with a bailout for the S&L's, overwhelmingly people telling me you can't hold up for these structural changes and yield to the short term. So once again that's why a moratorium is appealing and say let's stop everything in place while we carefully consider it—carefully consider it for the next decade. That has been the normal result of moratoriums. That's why I hesitate to go to one. It just delays it while the marketplace is moving around and finding other loopholes and other ways to go while we use the moratorium as an excuse for not making some tough decisions on various acts, many of them, as you know, are 50 years old. And I'm not prejudging what the outcome of those changes should be at all in McFadden or to Douglas or to the other acts that we're considering. I would just like to force Congress to make some decisions once in a while rather than taking the easy route and the moratorium is the easy copout.

Mr. **Patterson**. I think we share wholeheartedly your feelings. Our concern is obviously what's happening in the meantime in South Dakota and similar States.

Mr. **Nielsen**. I would totally agree with you, Mr. Chairman, that Congress must make some hard decisions. The alternative, however, is preemption by the States. South Dakota has passed a law. Delaware, if I had to guess, could possibly pass one by the end of this month in the current session of the general assembly. That, to me, is preempting Federal law which Congress has passed already.

I'm convinced we're moving too quickly to do what you would like to do to force the Congress to make some tough decisions. We would agree with you if they would act now.

The **Chairman**. That's always the excuse, that things are moving so fast we can't address them, and that's why they get deferred year after year. If it were a short-term moratorium that I knew would end in 6 months, as an example, we would take action during that period of time, that's one thing. But I would doubt very much that we would.

IMPORTANCE OF M'CARRAN-FERGUSON

How important is McCarran-Ferguson to you, Mr. Nielsen?

Mr. **Nielsen**. Very.

The **Chairman**. I assume all of you would share that view. The reason I bring that up is I want to reemphasize my feeling, as a former member of your profession, that I think that is one of the most valuable acts as far as the insurance business is concerned because you're about the last industry that isn't heavily stamped upon by the Federal Government. You maintain that States rights position as onerous as it may be at times to have to deal with 50 State legislatures and 50 State insurance commissioners. In my opinion, that is far preferable to the uniformity imposed in the rules and regulations that you could experience.

So one of the things that I think you have to watch very closely—and you've already seen some evidence of that—when you come and ask for the Federal Government to preempt in others areas that would be helpful to you, you will find that then people start talking about the regulation of insurance companies nationwide. There's already been some rumblings in the House about that.

I only throw that out as a caution. I think McCarran-Ferguson is extremely valuable. It is a principle that I will fight for to continue to keep the Feds from regulating the insurance business nationwide. So you need to be careful when you press very hard to say, Hey, we want the Feds to do this and preempt South Dakota and Delaware, even though for a worthwhile purpose." I don't like what is going on there either, but you don't want somebody to say, "Well, what's good for the goose is good for the gander." And if you want the Feds to come in and preempt South Dakota and Delaware and other States on particular issues, then the day comes when we simply say, "Well, fine, let's have uniformity throughout the country." So for whatever that's worth, and it may be not very much, I throw that out to you.

Mr. NIELSEN. May I respond to that for a moment, Mr. Chairman?

The CHAIRMAN. Yes, certainly.

Mr. NIELSEN. We recognize the problem and we would like to say—I think all my associates would join me—we very much believe in States rights. We don't think we are preempting States rights by our position. We believe the States can and should regulate and legislate their insurance and banking industries as they have in the past within their borders.

What we think is happening now is the banks are trying to circumvent Federal law, the Bank Holding Company Act, by using State-chartered banks. That's an entirely different situation. We believe the States can legislate anything they want within their borders, but that's not what's happening here. What's happening is a circumvention of the Federal law, at least as we see it. So we're all for States rights and allowing them to regulate and legislate as they see fit within their borders.

The CHAIRMAN. Thank you very much. My time is up on this round.

Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

Secretary Regan stated to us in past hearings on this subject that he would propose legislation to guard against unfair competitive advantages if lenders were to actively engage in the insurance business.

Do you see any legislation that could effectively guard against unfair tie-ins? Who would like to address that?.

Mr. GREGG. May I, please?

Senator HECHT. Please, Mr. Gregg.

Mr. GREGG. What I guess all of us are saying is that the rules, regulations, and law already have been establish by Congress and someone found a leak, and that's all that we're asking for, is that the leak be looked at in terms of congressional authority. No diminution of States rights, of State control of banks, but only an authoritarian look at the laws that now exist as established by Congress.

Senator HECHT. Well, besides a moratorium, what else would you suggest?

PROPOSE A ONE-STEP AMENDMENT

Mr. GREGG. Well, we went one step further in that in the back of our testimony we suggested a one-step amendment to the Bank Holding Company Act of 1956.

This would solve all problems today. I would suggest that it can't be done today, but if it were to be done today, it would solve all problems and we would go home and we would never appear here again. "No bank that is a holding company and no bank that is a subsidiary of such a holding company may directly or indirectly engage in any activity that is prohibited under section 4 of this act."

That was the intent of Congress originally and banks have been thwarting the will of the Congress in their actions in South Dakota and now their attempted or proposed action in Delaware. That would solve it if it were done today and do away with the moratorium.

Senator HECHT. Yes, Mr. Nielsen.

Mr. NIELSEN. Senator, as I understood your question, you're asking if there's any way to legislate against tie-in sales?

Senator HECHT. Yes. The Secretary said he was going to look into it.

Mr. NIELSEN. I wish him well. I'm not a lawyer by trade or training, but unfortunately I've had to spend a fair amount of time recently on this subject. I know the staffs of these four associations, who are far more knowledgeable than I, and also a number of legal firms representing the associations have spent a lot of time looking into how prohibitions to tie-in sales could be legislated. The answer is they can't be. There's an intangible leverage inherent in credit extension transactions. Certainly everybody wants to make tie-in sales illegal, and the proposed Delaware legislation says exactly that, that tie-in sales are illegal. It's like being for motherhood.

But I don't think you can legislate out the inherent leverage that the lending institutions have to consumers and corporations. An individual is not on an even keel when borrowing money from a bank.

So my answer is, I don't see how it can be done.

Senator HECHT. Mr. Patterson?

Mr. PATTERSON. I guess our frustration is—I agree wholeheartedly with Mr. Nielsen's comments—is that we felt we had the legislation and now there is a leak in the dike and we don't feel we have to reinvent the wheel necessarily. There ought to be some way to shore this up and get it back on the right track.

Senator HECHT. Let me ask you this question. Supposing the banks do have this. You are regulated by the States and the insurance commissioners in the different States. Who would regulate the banks on this? Now the FDIC goes through and looks at the reserve requirements and so on and so forth. What would be the answer? How would this be regulated? Would you have to have the insurance commissioners of the States tie in with the FDIC? This leaves a gray area here as to how this would be regulated if it were to happen.

Mr. NIELSEN. I can talk about the Delaware legislation. There have been a number of drafts in Delaware. I have not seen the most recent one, but as I understand it, a combination of the banking commissioner and the State insurance commissioner would serve as regulators. The proposed Delaware law is to have the insurance function as part of the bank, not as a separate subsidiary. An insurance subsidiary is the last thing the banks want in Delaware. The insurance function of a bank would be regulated by the insurance department and the banking function would be regulated by the banking commissioner. It's a little gray in between at the moment.

Mr. PATTERSON. But if you're referring specifically, Senator, to the national picture, obviously we have that policing mechanism in place right now in the Federal Reserve Board. One of our suggestions was, of course, that we ask by letter from this committee to the Board to please, please enforce title VI which is already in place.

Senator HECHT. So getting back to my first question. You really don't see any way we can stop the human element from trying these tie-in sales?

Mr. PATTERSON. We've spent an awful lot of time working on that and if that were the answer that would be a lot easier than what we are confronted with today, sir.

Senator HECHT. No further questions, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Hecht.

AUTHORITY TO ACQUIRE THRIFTS FOR 50 YEARS

In his testimony before the committee, Richard Pratt, former chairman of the Federal Home Loan Bank Board, stated that nonfinancial and nondepository institutions have had the authority to acquire thrifts for 50 years. I'm aware there are currently quite a number of thrifts that are owned by insurance companies. A couple of the regulators, including former Chairman Pratt, questioned why we would want to foreclose these options, either on a temporary basis through a moratorium or on a permanent basis. They have succeeded all these years without the dire consequences that are raised in your statements.

Would you comment on Chairman Pratt's position?

Mr. AKIN. Are you referring to the Allstate situation in California in particular?

The CHAIRMAN. No, not in particular. He's just talking about the fact that in S&L's many of these things have gone on for years and years and years and the dire consequences you predict have not occurred in those situations in those markets.

Mr. PATTERSON. Well, the powers of the savings and loans are not as great as a commercial bank, for one thing. Yes; they do make loans on homes and in some instances on commercial property as such, but they have never been able in prior years to extend credit, the situations that I mentioned earlier in the question and answer period.

The CHAIRMAN. At least in the mortgage field, they certainly have extended credit to a lot of homebuyers in the country and your concern about tie-in sales, isn't that a large concern of the tie-in sales when you're granting a mortgage loan?

Mr. AKIN. I think, Mr. Chairman, that the person borrowing money for a home mortgage is a once in a lifetime thing for some people. I understand the average loan is for about 8 or 9 years due to people moving and so forth. Savings and loans don't have the connection that the commercial banks would have. They don't have the exposure to the people on the regular basis. At least they haven't had. It would be interesting to see, with the broader powers that the savings and loans now have, what that situation looks like in a year or so.

Mr. GREGG. Also, on that level, Mr. Chairman, the lending institutions are in competition with each other to make those loans and the opposite is true on the banking level where the borrower is searching out someone that will make the loan to him. But as long as banks have access to the credit window and are insured by the Federal Deposit Insurance Corporation, as long as they are the lender of last resort, and as long as they attract demand deposits, and as long as they have a monopoly on short-term credit, then we have call for alarm and worry. It's a different ballgame.

Mr. **Wilson**. Mr. Chairman, my name is Tom Wilson and I'm IIAA Washington counsel. We in the last year tried a number of cases before the Federal Reserve Board in Missouri where S&L's have in fact been selling property and casualty insurance coverage in connection with their lending activities, and the unrebutted testimony in the record in those proceedings is that indeed they behaved pretty much the way an awful lot of other lenders behave when they're permitted to sell insurance in conjunction with extensions of credit.

We proved it was virtually impossible to find an independent agent in the State of Missouri—and we looked for them—who had significant insurance policies on new tracts of homes. Those tracts of homes were typically financed by the S&L's. They would bundle the deals up working with the realtors and with the construction people and then it turned out that they were also selling insurance to the permanent home buyer once the deal was closed. And it was made very clear by the S&L's—and there was a lot of anecdotal testimony in the record to support this—that the independent insurance agent insofar as selling insurance in these tracts need not apply, and they did it really very effectively.

So the S&L's are not any different from anyone else. They just haven't been subjected, because of the way that they have been regulated, to the kind of scrutiny perhaps that, because of section 4(c)(8) of the Bank Holding Company Act, the bank holding company has been subjected to.

[Additional comments on savings and loan associations having the authority to act as agents in the sale of property and casualty insurance.]

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THOMAS E. WILSON

June 20, 1983

BY HAND

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
Room 5300
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Senate Banking Committee
Oversight Hearings (June 7, 1983)
-- Insurance Producer Group Panel

Dear Senator Garn:

On June 7, 1983, a panel of insurance producer groups that included the Independent Insurance Agents of America, Inc., the National Association of Casualty and Surety Agents, the Professional Insurance Agents, the National Association of Life Underwriters, and the National Association of Insurance Brokers, presented testimony to the Senate Banking Committee in connection with the Committee's ongoing oversight hearings into matters relating to the financial services industry. We served as counsel to the producer group panel during the testimony.

During the question period that followed the testimony of the insurance producer groups, you requested comments on a statement made by former Chairman Charles T. Pratt of the Federal Home Loan Bank Board that savings and loan associations have had the authority to act as agents in the sale of property and casualty insurance for a number of years without resulting in any of the market abuses about which insurance producers expressed concern.

The insurance producer panel provided testimony that the hearings held last year by the Federal Reserve Board in connection with the applications of two Missouri bank holding companies for authority to act as agents in the sale of property and casualty insurance produced uncontroverted evidence that savings and loan associations in Missouri have in fact exploited the competitive advantages conferred upon them by their power to sell property and casualty insurance products as well as extend credit. We are enclosing for your information -- and for inclusion in the record of the

Committee's hearings -- excerpts from the records of the Federal Reserve Board proceedings. Those excerpts summarize the evidence adduced during the Federal Reserve's hearings on the savings and loan association/insurance tie-in problem.

Should you have any questions, or should you require any additional information, please let us know.

With best regards,

Sincerely,

SPRIGGS, BODE & HOLLINGSWORTH

By: Thomas E. Wilson

Enclosures

cc: Mr. Gerald K. Cassidy (w/encs.)
Mr. Richard Nielson (w/encs.)
Mr. Thomas Gregg (w/encs.)
Mr. Edward Aikin (w/encs.)

June 20, 1983

Applications of Mercantile Bancorporation, Inc. and Commerce Bancshares, Inc. for Authority to Engage in Property and Casualty Insurance Activities

Excerpts from the Sworn Testimony of IIAA Witnesses

Abusive Practices of Savings and Loan Associations In Sales of Insurance in Connection with Extensions of Credit

Excerpt from the Sworn Written Testimony of IIAA Witness E. Ellwood Willard, President of Willard Insurance, Inc. of Lebanon, Missouri and an insurance agent with forty years of insurance experience (Exhibit IIAA C-13, at 34-37) --

The savings and loan associations in Missouri have been permitted to run insurance agencies through their service corporations for a number of years. United Savings and Loan Association is a savings and loan association that has been selling insurance in Lebanon, Missouri, for some time. I have had a number of experiences with United's insurance operations that graphically illustrate the power of lenders to sell property and casualty insurance in conjunction with extensions of credit.

On one occasion, one of my employees and her husband decided to purchase a house. This was to be their first home and they were excited about the purchase. They shared their good feelings about the home with their friends. They had made arrangements to finance the house through the United Savings & Loan Association. Their loan request had been approved and the closing date set. My employee asked that she be permitted to furnish the insurance coverage on the house through our agency. She requested this for three very good reasons: (i) she was a loyal employee of the agency; (ii) our rates were lower; and (iii) she would be given the commission produced by the policy. When the loan papers were being signed at the closing, my employee noticed in the closing costs an item entitled "hazard insurance."

She inquired as to what hazard insurance was and was informed that it was the fire and extended coverage on the dwelling. She reminded the loan officer that she had previously been assured that she could provide the insurance. She then gave them the policy she had written through our agency. The loan officer told her that he was sorry but he could not close the loan at that time unless things were left as they were because the Board of Directors had approved the loan with the S & L writing the insurance. He went on to say that, if she insisted on providing the insurance, her loan would have to be resubmitted to the S & L Board.

The pressure this situation placed on this young couple was enormous. They had told all their friends that they would be moving into their new home immediately only to find that that would not be possible. I can tell you that at that point most young couples would have backed down and let the S & L supply the insurance on the property and returned the other policy to our agency for cancellation. Since my employee had been forewarned that such could happen and because she knew that we would back her up, she stood her ground and refused to go through with the closing. I received a call shortly thereafter from the President of the S & L telling me that my employee had "misunderstood" and that he was sorry for what had happened. He asked that I tell her to come back to their office and they would complete the loan.

As Chairman of my church's Finance Committee, I experienced another situation when the lender just assumed they would sell the insurance covering collateral for supporting a loan they were making. The Board of Trustees of the church arranged to purchase a dwelling next door to our church. Again, arrangements for financing were made through the local savings and loan. When our church's Finance Committee reviewed the loan papers, it was noted the S & L had included in the closing costs the premium for the insurance on the property being purchased. I advised the Trustees that the coverage on the new property could be added to the church's existing insurance policy, thereby giving the church better coverage at a lower cost. When the Trustees told the S & L that they would add the property to the existing policy, the S & L was quite unhappy but again went along. If no one who was knowledgeable about insurance had reviewed the transaction, there is no question that the insurance would have been sold by the S & L to the detriment of the church.

On another occasion, I insured a merchant in Lebanon who owned a clothing store. He decided to expand his business by purchasing the building adjacent to it and knocking out a wall. He consulted me and I told him to let me know when he got started so we could make appropriate adjustments on his insurance policies. After not hearing from him for a while, I called him to ask him how things were going and what he was doing about his insurance. He informed me that the insurance on the adjacent building was being handled by the savings and loan that was providing the financing on the adjacent building. I advised him that he should either have me sell him the insurance on both buildings or arrange for the savings and loan to do it. To have both of us involved was going to cost him substantially more than would otherwise be the case and would create a serious danger that the policies might not be in perfect concurrence (cover exactly the same kind of risks), thereby creating a situation where in the event of a loss both carriers might refuse to pay on the theory that it was the other carrier's responsibility. The merchant did not take my advice and paid the extra premium for insurance from the savings and loan association. The only explanation for the merchant's actions is that he felt some implicit obligation to give the savings and loan affiliated insurance agency some business, even if it was not entirely in his interest to do so from a purely insurance perspective.

* * *

Excerpt from the testimony of IIAA witness Ronald A. Ollis, principal of Ollis & Co., Inc. of Springfield, Missouri and an insurance agency with twenty-five years experience (IIAA Exhibit C-14, 19-22) --

For many years, savings and loan associations in Missouri have been selling property and casualty insurance through their service corporations. My father got started in the insurance business by acting as an agent in Springfield for customers referred to him by United Savings

& Loan Association, an S & L that was then headquartered in Lebanon, Missouri. Eventually, United opened up its own insurance agency facility in Springfield. The United agency ended up writing all of the insurance that had previously been written for United borrowers by Ollis & Co., Inc. For a long time thereafter, it was extremely difficult for us to sell any homeowners insurance on new homes. In fact, to this day, the vast majority of the homeowners insurance accounts that we handle are on re-sales (as opposed to new homes) and on very expensive new dwellings that are not financed through S & Ls. For many years, now, almost all of the homeowners insurance that is sold on new development homes is sold by the savings and loan affiliated agencies. The savings and loans make the loans to purchase the homes and they see to it that they sell the insurance as well. It is very profitable for them.

If we were given the opportunity, we could easily out-compete savings and loan affiliated insurance agencies, even on homeowners insurance. Savings and loans, however, have used all sorts of techniques to make it very difficult for a person who borrows money from them to buy his homeowners insurance from any other source. On one occasion some years ago, I was asked to write the insurance on a home that was being purchased by the national chapter of Kappa Alpha fraternity for use by the Kappa Alpha chapter at Southwest Missouri State University. I did a work-up on the property and gave the policy to a local Kappa Alpha representative to present at the closing. The policy was passed on to another Kappa Alpha representative who was sent out from Washington to attend the closing. The closing was scheduled on a Saturday. At closing, the S & L refused to accept the policy I had prepared. Indeed, the Kappa Alpha representative was told that the closing could not be completed unless the S & L affiliate supplied the insurance. Faced with having to return to Washington empty-handed, the Kappa Alpha representative gave in and let the S & L provide the insurance. After returning to Washington, he returned the policy that I had prepared and asked that it be cancelled.

On other occasions, I have had savings and loan associations refuse to accept insurance policies written by our agency unless they were personally delivered to the savings and loan association by the agent at closing -- they would not accept an insurance policy or a certificate of insurance that was sent through the mail. In still other instances, I have had them accept my policies and charge my insureds a $15 "service fee" for their trouble.

Over the years, I had had occasion to analyze a number of homeowners policies sold by insurance agency affiliates of savings and loan associations. Very often I have found that the insurance had been written based on the amount of the loan made by the savings and loan association, and not based on the insurable value of the home. The lender therefore was fully protected; the borrower, however, was not. On other occasions, I have found that I could provide the same or more insurance at a lower cost. Nevertheless, I have seldom been able to persuade an insured that he should switch his insurance coverage. I have had expressed to me concerns that the savings and loan association might make it difficult for the borrower in some way later on. Quite often, the fears expressed by these people have been unfocused. Nevertheless, in my experience, there is no question that people feel uneasy about doing anything that they think might be displeasing to the lender. Since the range of insurance options available to consumers is generally not within their own knowledge and experience, and since the cost savings that a consumer may get by buying his insurance somewhere else are relatively small in relationship to importance of the loan transaction, it is an easy matter for a lender to take full advantage of its superior bargaining position over the borrower by selling him insurance that is either inadequate or over-priced, or both.

* * *

Excerpt from the sworn testimony of Irving H. Plotkin, Vice President of Arthur D. Little, Inc. and an economist who has studied tie-ins between sales of insurance and extensions of credit for twenty years (IIAA Exhibit C-10, 8-9) --

In the context of title insurance, the ability of the lender to control the selection of a title insurer by the mortgage borrower, for similar reasons, is equally present. The most striking example of lender power with which I am personally familiar involves the largest S & L in Minnesota, Twin City Federal Savings & Loan Association of Minneapolis.

In approximately March of 1979, Twin City acquired a 52 percent interest in a relatively small, local title insurance agency, North Star Abstract & Title Company. As of April 1979, over 80 percent of the abstract and title insurance business for loans made by Twin City was being handled by a large, national (and, of course, independent) title underwriter, the Title Insurance Company of Minnesota, headquartered in Minneapolis. The North Star Abstract & Title Company had approximately 12 percent of Twin City's abstract and title business. By August 1980, less than a year and a half later, those percentages had been more than reversed. Specifically, in Hennepin County, the county in which Minneapolis is located, the North Star agency was doing over 83 percent of the title business generated by Twin City, while Minnesota Title's percentage had shrunk to less than 10 percent (Attachment 3). In my opinion, nothing could illustrate more starkly the ability of lenders to control the selection of ancillary products and services paid for by borrowers in connection with an extension of credit.

* * *

ATTACHMENT 3

TITLE INSURANCE COMPANY OF MINNESOTA

C. J. McCONVILLE
PRESIDENT

September 22, 1980

Dr. Irving Plotkin
Arthur D. Little Inc.
25 Acorn Park
Cambridge, Massachusetts 02140

Dear Mr. Plotkin:

You and I were discussing the effects of controlled business recently and I mentioned what our recent experience had been in Hennepin County of which Minneapolis is the county seat.

The largest savings and loan in the state is Twin City Federal Savings and Loan Association (TCF) with over $2,000,000,000 in assets. Approximately in March of 1979, TCF acquired a 52 percent interest in a local title company, Northstar Abstract and Title Company. Enclosed is an exhibit which shows the number of mortgages that were recorded by TCF and the dramatic shift in the business from ourselves to the controlled agent.

In April, 1979, we handled over 80 percent of this savings and loan's mortgage business--either through abstracts or title insurance; Northstar had 12 percent. In the month of August, 1980, those figures were more than reversed...Northstar had 83.3 percent of their business while we had 9.8 percent.

I believe that this graphically illustrates how the ownership of a title company by a savings and loan service company can have a significant impact on the marketplace.

Best regards,

President

CJM:mrm

400 SECOND AVENUE SOUTH • MINNEAPOLIS, MINNESOTA 55401 • (612) 371-1111

HENNEPIN COUNTY

TWIN CITY FEDERAL MORTGAGES RECORDED

	Minn. Title	Northstar	Total*	Minn. Title Percentage*	Northstar Percentage*
April 1979	220	33	271	81.1	12.1
May 1979	193	81	294	65.6	27.5
June 1979	166	148	331	50.1	44.7
July 1979	175	208	399	43.8	52.1
August 1979	134	128	277	48.3	46.2
September 1979	82	101	198	41.4	51.0
October 1979	58	107	180	32.2	59.4
November 1979	76	168	250	30.4	67.2
December 1979	80	192	293	27.3	65.5
January 1980	65	173	263	24.7	65.7
February 1980	41	60	104	39.4	57.6
March 1980	15	65	83	18.0	78.3
April 1980	23	96	125	18.4	76.8
May 1980	13	80	98	13.2	81.6
June 1980	13	38	58	22.4	65.5
July 1980	10	24	37	27.0	64.8
August 1980	13	110	132	9.8	83.3

*These do not total 100 percent because a small percentage of the business is handled by some of the other compeitors--there are a total of 8 title companies doing business in Hennepin County.

The CHAIRMAN. As we have discussed, title VI of the Garn-St Germain specifically prohibits certain insurance activities but it also specifically permits bank holding companies to provide credit life, disability, and unemployment insurance. Aren't the risks of tie-ins large in those areas too, and yet there's no opposition to those lines. Anybody who wishes to not monopolize?

Mr. NIELSEN. Of course the risks are the same, but I think our position is that those areas were given to the banks before, and we're not going to argue about it at this stage. It's gone beyond that. I think there are a number of studies, including one by the Federal Reserve, showing that on the credit life side particularly, most consumers thought they had to buy credit life from the bank. They thought it was part of the loan package. I don't think we're here today to argue about insurance authority extended in earlier legislation, but, yes, the same thing is true.

The CHAIRMAN. Mr. Cassidy.

Mr. CASSIDY. Mr. Chairman, I don't believe the consumer interest and the anticompetitive interest in this situation of tie-ins can be ignored. When the lending institution ties in the commercial program, which they do—I'm very familiar with that since part of my experience, in the past, I was in the general agency business which is sort of a wholesale level and not so popular today in the big cities— but in that experience of some 20 years, we had retail outlets in two or three of the major banks here in the Washington, D.C. area, prominent Pennsylvania Avenue-type banks. I'm quite familiar with the use of tie-ins as an influence in lending and I'm also very familiar with the level of continuing professional service provided by that level, and it's not competitive in pricing or service and certainly, in my opinion, is not in the consumers' best interest. I think you should not ignore that.

INTIMIDATION OF THE AVERAGE MAN ON THE STREET

Mr. **Gregg**. Mr. Chairman, the psychology of this type of thing has to be looked at, too. The exemptions contained in the Garn-St Germain bill reflect credit-related insurance purchases that are "closely related to" banking. But what we're concerned about is the ongoing psychology of the intimidation of the average man on the street. No one in this room, myself included, but the average man on the street is intimidated when he opens the door of a bank. He takes off his hat and he is in a psuedo begging position at that time. I know because I have been there. I spent a number of years in that water and it was always cold, and I had to go in and borrow money. And I can assure you, sir, that at no time that I ever questioned an interest rate or anything that went with the package. I was so desperate, usually, that I would sign any piece of paper put in front of me and I don't think that's changed. I think people are still intimidated by banks. The average man on the street that we are concerned with—we're concerned with everybody, but the average man on the street doesn't have the wherewithal, the knowledge, the contacts that we now have in our business world, and they need that kind of ongoing protection.

The **Chairman**. Senator Hecht.

Senator **Hecht**. Mr. Gregg, with this high interest in the last few years and the shortage of money, it's gotten even worst. I have been on the other side, too.

Mr. **Gregg**. I was as recently as 60 days ago—and I was relating this last night—that I literally have not borrowed any money from my friend and banker in Topeka for a long time, but I had to go again because Uncle Sam had to be paid, and I had about a 5-day lapse in there that had to be covered. And I can assure you that after many years of not having to borrow, I felt funny once again going. He had to have a financial statement, the whole ball of wax, and he said, "Tom, I've got to have this. You know the examiners might come in." And I felt again that I was intimidated by being there and being put in a semi-begging situation. It's there, isn't it?

Senator **Hecht**. Of course it is, and you always use the excuse of bank examiners.

Mr. **Patterson**. It's very real and possible.

The **Chairman**. Well, if you all practice what my father did, he never got in that position because he never borrowed any money. My parents saved for 15 years to pay cash for the only house they ever owned and he would be shocked to know what I've borrowed in these years.

Gentlemen, I have no additional questions at this time. I do expect that there will be other questions for your response in writing from other members of the committee and possibly we will have some more detailed specific questions for you as well.

Do any of you have any closing remarks you wish to make? If not, thank you very much for coming.

Mr. **Patterson**. Thank you very much.

Mr. **Gregg**. Thank you.

The **Chairman**. If we could have the next panel come up, please.

We are very pleased to have before us in the second panel today Richard Schweiker, a former colleague of mine. We shared the back row of the Senate floor for a number of years. We deliberately sat on the back row so we could sit and laugh at the rest of the Senate without having to turn our heads from side to side. And the thing that bothers me, Dick, is you look so much more prosperous since you left public life.

We are very happy to welcome back a good friend and it's nice to see you here. Also, Mr. William W. Suttle, senior vice president for Federal affairs, American Insurance Association; and John Nangle, assistant vice president of the National Association of Independent Insurers.

Mr. Secretary-Senator, please proceed.

STATEMENT OF RICHARD S. SCHWEIKER, PRESIDENT, AMERICAN COUNCIL OF LIFE INSURANCE

Mr. SCHWEIKER. Thank you very much, Mr. Chairman and Senator Hecht. I'm delighted to be here and to have a chance to renew friendships as well as present a position on behalf of the American Council of Life Insurance. I appreciate the opportunity to appear before this committee to express our views concerning the dramatic changes that are now taking place within the financial services industry.

The council is gravely concerned with recent legislative and regulatory initiatives that would permit depository institutions to engage in a broad spectrum of commercial endeavors, including the sale and underwriting of insurance. These initiatives raise serious questions about the impact that integration of diverse businesses will have on the safety and the soundness of the institutions involved and on the continued efficacy of the various systems of regulation that exist to protect the public.

We believe that the oversight hearings being conducted by this committee are timely and necessary if a system of orderly governance of financial institutions is to be maintained. We feel strongly that prompt action by Congress in addressing particular aspects of the present deregulatory process is essential to the preservation of that orderly system.

The functions of banking and insurance have historically remained separate under the scheme of both State and Federal regulation. This committee, and subsequently both Houses of Congress, considered this separation last year and, as reflected in the Garn-St Germain Depository Institutions Act, concluded that it should be preserved. Title VI of that act explicitly prohibits bank holding companies and their subsidiaries from engaging in the business of insurance except in narrowly limited, clearly specified instances. The life insurance industry strongly supports this law and its underlying principles. It does not believe that events since the bill's enactment last year warrant any change in policy.

I would like to address briefly why we believe the general separation of banking and other forms of commerce, particularly insurance, is appropriate. Let me begin with a general economic consideration.

ECONOMIC CONSIDERATIONS

Commercial bankers have suggested that banks must be permitted to engage in a wider range of financial services in order to be competitive with other types of financial service institutions. However, for freer financial markets to achieve the desired efficiency goals that competitive theory predicts, they must be free not only to bestow profits on successful innovators, but also to impose the sanction of loss and ultimate failure on enterprises that make wrong decisions.

It is the necessity of preventing bank failure, stimulated by public demand for a stable banking system, that has shaped banking legislation in the past and underscored the belief that banks are uniquely important and deserve special treatment. This attitude is best illustrated by the existence of the Federal deposit insurance and bank access to Federal Reserve discount window, features of the banking regulatory system which fundamentally conflict with free market theory.

The most critical issue in the debate over deregulation of the banking industry is how—or indeed whether—policymakers should compromise between the public's demand for a stable banking system and the free market theory, with its explicit endorsement of the freedom to fail. In this context, life insurance companies are also members of the public demanding a stable banking system and rely on that system for their own continuing viability.

Turning specifically to insurance, the activities of State legislatures have become one of our most serious concerns. The South Dakota Legislature in early March enacted a measure sponsored by several money center bank holding companies which allows a State chartered bank to engage in all facets of the business of insurance either directly within the bank or through a subsidiary. Another provision permits South Dakota banks to be acquired by out-of-State entities, for example, money center bank holding companies. Also the bill operates to constrain a South Dakota bank's insurance operation from selling insurance in South Dakota, although sales in other jurisdictions are expressly permitted.

The intent and purpose of this exercise is as transparent as it is inappropriate—to circumvent the clearly expressed intent of Congress in the Garn-St Germain Act to limit severely the insurance activities of bank holding companies. The legality of this maneuver is questionable and we anticipate it will be challenged administratively as well as in the courts. The same theory, if it were to succeed in this instance, could be used to permit State chartered banks, including those that are part of a holding company complex, to underwrite securities or manufacture automobiles or operate gambling casinos. More disturbing, if it's allowed to succeed, such legislation will signal that the control of the national banking system is no longer in the hands of the Congress and the Federal banking regulators who are responsible to the public for the safety and the soundness of that system.

CONCERNS ABOUT THE INTEGRATION OF BANKING AND INSURANCE

I would stress that we are not opposed to States rights. However, this blatant attempt to circumvent Federal law should not be sanctioned under the banner of federalism.

There are several other specific reasons why the committee should be concerned about the integration of banking and insurance.

The first of these involve solvency. As noted by Federal Reserve Chairman Volcker in recent testimony before this committee, it's well nigh impossible to completely insulate from one another the various activities of a single organizational entity. The fortunes of one activity invariably influence the fortune of the others. Simply stated, where banking and insurance are conducted within the same legal entity, customers of its commercial and insurance departments will each be faced with unbargained-for risks. The insurance industry feels very strongly that when consumers purchase insurance products they should not have the security and protection afforded them by those products imperiled by unsound banking practices.

I would suspect that commercial bank customers would agree that the converse is equally undesirable. Yet this is precisely the result that can be expected under the South Dakota law and similar proposals now under consideration.

A second important consideration is tie-in sales. When individuals or businesses come to a bank seeking extensions of credit, they often come hat in hand. We heard that very well described by the preceding witness. They need that money, and often they know that a denial of credit can have dire consequences. Quite understandably, in such circumstances people are susceptible to the suggestion, expressed or implied, that they may be more likely to get a loan if they agree to purchase additional bank services.

The fear that banks will use the leverage of their unique lending powers to encourage the sale of nonbanking services has been echoed by many of the witnesses before this committee as the members of this committee well know. Insurers have better reason than most to express such a concern. There is a substantial record of testimony before this committee, not only this year but in the years past, to indicate that tie-ins by banks involving extensions of credit and the sale of credit life and disability insurance are commonplace.

We've all heard the banks say that they do not engage in tie-ins because tie-ins are illegal, and so they are. But prohibiting tie-ins and preventing them from occurring are two very different propositions, and the effective prevention of tie-ins has received very little consideration in debate over the expansion of bank powers.

It's arguable that because of the importance of their lending powers, banks occupy such a unique position that the mere offering of other services is inherently coercive.

Several other specific concerns arise in the context of the deregulation proposal advanced last year by the Treasury and mentioned by Secretary Regan in his recent testimony before this committee. Rather than commenting, at any length on our objections to that proposal, we have attached as an appendix to this statement our testimony delivered before Senator D'Amato's Securities Subcommittee on February 12, 1982, which fully treated that issue.

Mr. Chairman, the haphazard integration of financial services intermediaries now occurring obviously cannot be laid at the feet of depository institutions alone. Bankers, thrifts, securities companies, and insurers have all mounted expeditions to the far reaches of existing law and beyond in an effort to see how many different financial services can be brought together within one company or one corporate complex. Perhaps this is understandable, since no one wants to be the last to avail themselves of a perceived competitive advantage. So long as the various doors remain open, all providers of financial services, insurance companies included, will be scrambling to acquire still more services by whatever means available. We believe this is the least desirable way to achieve change in an area so fundamentally vital to the Nation's economic well-being.

The Federal Reserve Board is reportedly prepared to propose a moratorium on the integration of financial services which would give Congress an opportunity to develop a fair, orderly approach to deregulation. While there are specific portions of the moratorium proposal for which the Council has not yet established policy, and which we may not feel are appropriate, we support the overall concept of the moratorium as a means of providing Congress with the opportunity to review carefully the many important issues involved.

BEGINNING OF A RACE BY STATES

Whether or not Congress enacts a broad moratorium, however, we believe that prompt action must be taken to prevent the circumvention of title VI of the Garn-St Germain Act as has been recently attempted in South Dakota. As Treasury Secretary Regan noted in his testimony before this committee, the South Dakota law is unfortunately likely to be just the beginning of a race by the States to see who can regulate banking the least. Indeed, similar measures have been proposed or are under consideration in other States, most notably Delaware. I read recently that the banking organization that was a principal backer of the South Dakota law has suggested that if Delaware will enact a similar law, it would consider headquartering its insurance operations there rather than in South Dakota. If this is the case, it certainly does not reflect a sound reason for deregulating a major industry.

Attached to our statement for the committee's consideration is proposed legislation which would amend the Bank Holding Company Act to make it clear that State bank subsidiaries of bank holding companies may engage in insurance activities only to the extent permitted under section 4(c)(8) of the act. By enacting the amendment to the Bank Holding Company Act we propose, Congress will be able to retain the flexibility to oversee the changing financial services industry despite the legitimate exercise of State legislative prerogatives, while at the same time giving full meaning to the provisions of title VI of the Garn-St Germain Depository Institutions Act of 1982.

Mr. Chairman, that concludes my prepared remarks. I want to thank you and the committee once again for the opportunity to testify and, at the appropriate time, I'll be happy to answer any questions the committee may have. Thank you.

[The complete statement follows:]

STATEMENT OF THE
AMERICAN COUNCIL OF LIFE INSURANCE

Before the

SENATE COMMITTEE
on
BANKING, HOUSING AND URBAN AFFAIRS

on

DEREGULATION OF THE FINANCIAL SERVICES INDUSTRY

June 7, 1983

Statement made by:

Richard S. Schweiker
President
American Council of
Life Insurance

Mr. Chairman and members of the Committee, my name is Richard Schweiker, President of the American Council of Life Insurance. The Council is the principal trade association for life insurance companies and has a membership of 573 stock and mutual insurers. These companies represent approximately 95% of the assets of all United States life insurance companies and 99% of the assets of insured domestic pension plans.

The Council appreciates the opportunity to appear before this Committee to express the views of the life insurance business on the important issues concerning the dramatic changes occurring within the financial services industry and the regulatory changes being proposed to meet the unfolding needs of that industry.

Speaking from the perspective of its member life insurance companies, the Council is gravely concerned with recent federal and state banking initiatives -- none of which has been sanctioned by Congress -- that would permit depository institutions to engage in a broad spectrum of commercial endeavors, including the sale and underwriting of insurance. In all of these initiatives, we perceive a lack of thoughtful consideration of the impact that integration of diverse businesses will have on the safety and soundness of the institutions involved and on the continued efficacy of the various systems of regulation that exist to protect the public as well as the soundness of those institutions. Rather, they are being sold either as measures that would create jobs and tax revenues or as a means of enhancing competitive posture and profitability. Ignored are fundamental competitive and regulatory inequities that, if permitted to exist, will operate to harm both the consuming public and the Nation's financial institutions.

The oversight hearings being conducted by this Committee are timely and necessary if a system of orderly governance of financial institutions is to be maintained. We feel strongly that prompt action by Congress in addressing particular aspects of the present deregulatory process is essential to the preservation of that orderly system.

The functions of banking and insurance have historically remained separate under the scheme of both state and federal regulation. This Committee, and subsequently both Houses of Congress, considered this separation last year and, as reflected in the Garn-St Germain Depository Institutions Act, concluded that it should be preserved. Title VI of that Act explicitly prohibits bank holding companies and their subsidiaries from engaging in the business of insurance except in narrowly limited, clearly specified instances. The life insurance industry strongly supports this law and its underlying principles; there have been no events since the bill's enactment last October that would warrant any change in policy.

I would like to address in some detail why we believe this general separation of banking and insurance is appropriate and, in so doing, point out the problems inherent in the various legislative proposals addressing this issue that have been advanced to date.

BROAD CONSIDERATIONS

There are several specific reasons why banking and insurance should remain discrete activities. Of overriding importance, however, are two broad considerations that, by themselves, fully justify the historic delineation.

Economic Considerations

Commercial bankers in pressing for further deregulation of their industry argue that banks are being forced by the existing regulatory system to operate at a serious competitive disadvantage. While other types of institutions are being allowed to offer services highly competitive with many bank functions, bankers complain, free-entry is working in only one direction. They suggest that too often legal and regulatory constraints prevent them from effectively competing through entry into markets where other types of institutions are the traditional financial service suppliers. Those restraints, it is argued, reflect an outmoded regulatory theory that has no relevance in today's world of rapidly changing and increasingly competitive financial markets.

Essentially, then, the argument for deregulation is tied to the arguments for a free-market system. But for freer financial markets to achieve the desired efficiency goals that competitive theory predicts, they must be free not only to bestow profits on successful innovators, but also to impose the sanction of loss and ultimate failure on enterprises that make wrong decisions. Only then can management be expected to exercise the necessary prudence in decision-making that is required to achieve the predicted optimum allocation of resources.

The history of banking and its regulation in this country make it clear that the public does not want the banking industry to fit into a framework that readily tolerates business failure. Past experience with widespread banking failures at times of financial panic has caused the public to place a high premium on a stable banking system in which economic dislocations and personal losses arising from bank failures are held to a minimum. The public wants reassurance that the banking system will always provide both a quick and efficient means of making payments, available on demand, and an assured backup source of liquidity to business and the public at large.

In this context, life insurance companies are also members of "the public." As such, they too must rely on a stable banking system to ensure their own continuing viability.

Over the years Congress has enacted a number of laws that are responsive to this public demand for a stable banking system. In the process, it has acknowledged that financial institutions whose liabilities provide a major part of the Nation's payment system are uniquely important and, consequently, require special treatment.

In short, the basic issue posed by efforts to substantially deregulate the banking industry is how -- or indeed whether -- policy-makers should compromise between the public's need for a stable banking system and the free-market theory (with its implicit endorsement of the freedom to fail) that underlies the case for bank deregulation. The inherent contradictions involved in these two disparate conceptual approaches are best illustrated by looking at a few practical examples.

Deposit Insurance. Federal insurance of bank deposits serves two functions: first, it assures those who hold relatively small balances in a bank, and lack the resources to monitor the performance of bank management, that their deposits will be secure; second, with insurance providing a sense of security to individual depositors, the bank itself tends to be protected against "runs" by depositors making panicky mass withdrawals. Because of this sense of security provided by deposit insurance, bank managements generally have been able to rely on the maintenance of a sizeable and relatively stable volume of "core deposits." Even at larger banks that rely increasingly on a significant margin of much more volatile "purchased" funds (such as large certificates of deposit, reverse repurchase arrangements, federal funds, and Euro-dollars), the presence of a relatively stable core of insured deposits serves to limit the risk of unexpected fund outflows.

When depositors are protected by federal insurance, however, they tend to look to the perceived soundness of the insurance fund, rather than to the quality of the bank's management, as the ultimate source of their deposit security. Consequently, most depositors in practice simply assume that the federal guarantee is reliable and pay little attention to the management of the bank. To the extent the question of bank management arises, depositors tend to assume that federal regulators are watching, if only to limit the risk of inordinate drains on federal insurance funds. Indeed, it has been established federal banking policy for many years that "full disclosure" -- a concept that guides the obligations of all other public companies in the "free financial services markets" -- is inappropriate for banks since, in the case of unsound bank management practices, it would only lead to depositor uneasiness and prompt the very reactions that bank regulators are seeking to prevent.

With the Administration pressing for further relaxation of regulatory constraints on banks and with state enabling legislation threatening to move insured institutions into non-traditional businesses without regard for federal regulatory concerns, there is an increasing acknowledgement that changes in regulatory procedures will be necesary if risk taking by bankers is to be kept within reasonable bounds and the soundness of the banking system and its deposit insurance funds is to be preserved. Essentially, the changes being considered seek to make the discipline of the private market bear more effectively on decisions by bank managements.

Three types of reform have been discussed. One would link the insurance charges paid by an individual bank to the relative riskiness of the operations in which it is engaged. A second would require depositors with "excess deposits" (the margin that exceeds the $100,000 insurable maximum) to share losses on this excess with the FDIC when failing banks are merged with stronger banks under purchase and assumption arrangements. The third proposal would require banks to make more revealing statements as to their basic operating condition.

While all of these proposals seek to address the basic need for effective sanctions, each also poses important practical problems of implementation. For example, many bankers strongly resist the idea of differential deposit insurance rates, partly because this would result in significant added costs, but also because of the difficult definitional questions involved. To deal with the definitional problems, it has been suggested that private deposit insurance might be substituted for federal insurance, since private, profit-oriented firms could be expected to make a more meaningful underwriting decision than federal insurers on how insurance costs should be graduated in relation to risk.

The public insurance system, however, has an inherent advantage over any private system, because it can impose management reforms on troubled institutions (through regulatory action) before those firms actually fail. Moreover, the need for such advance action can be identified through regulatory surveillance. These powers have been highly effective in minimizing the costs of public deposit insurance. Since private insurers would not have these regulatory powers, the risks and costs of private insurance would be higher. As a result, the scales clearly are tipped in favor of utilizing the public insurance system already in place.

The proposal to require holders of excess deposits to share losses with the FDIC in purchase and assumption mergers is designed to make large depositors more sensitive to differences of management risks among banks. The particular plan being discussed would make excess deposits "whole" for only 75 percent of their stated value, instead of the 100 percent that has typically been allowed under existing FDIC practice.

This FDIC proposal to share losses with holders of excess deposits has been criticized on two counts. On the one hand, it is argued that the largest depositors are already quite sensitive to any evidence that a given bank is being mismanaged. In practice, they, therefore, tend to take protective action well in advance of an actual failure--by halting business with the bank in question on such things as purchases of large CDs or sales of federal funds. For such depositors, the imposition of the proposed 75 percent limit on insurance pay-offs would exert little influence.

At the same time, however, the share of depositors that regularly review their changing risks and make the requisite protective adjustments is probably quite small. This present general insensitivity to changing risks undoubtedly reflects the current FDIC practice of making even the excess balances of troubled banks whole, except for the rare cases where smaller institutions are liquidated. If the 75 percent rule were adopted, it would, therefore, be likely to make most holders of excess balances considerably more skittish than they are now. During periods of general financial strain, such added concerns could considerably augment the vulnerability of the U.S. financial system to banking runs.

Even on the question of more forthright public reporting, there are some who counsel caution. The requirement of full reporting is recommended as a deterrent that will exert pressure on bank managements to avoid risky activities that might require unfavorable future condition reports. Experience suggests, however, that a number of institutions will get into trouble anyway. At times of general liquidity strain, publicity accorded such evidence of a deterioration in financial reports could operate counterproductively to accentuate financial instability.

In short, many basic questions still need to be resolved before it can be shown that an effective system of federal deposit insurance of the type generally supported by the public can be made compatible with the goal of further bank deregulation.

Lender of Last Resort. While proposals for bank deregulation give rise to the prospect of financial loss and possible ultimate failure, federal regulators in practice have generally interpreted the public interest to require that they endeavor to minimize the likelihood of bank failures. As a result, when banks have encountered financial difficulties, credit has usually been provided on a temporary basis through the Federal Reserve discount window to try to help them work their way out of these problems. If it becomes clear that a troubled institution is no longer economically viable, the regulators generally attempt to merge that institution with a stronger entity rather than tolerate a failure and liquidation.

One reason the regulators attempt to stave off outright liquidations is to minimize the size of potential drains on federal insurance funds. More generally, however, the merger route is adopted to minimize whatever broader economic repercussions to other financial institutions might be triggered by a major liquidation.

If the ultimate sanction of failure and liquidation is to be generally avoided (particularly for larger banks), there clearly will be a continuing need for the exercise of extreme caution by federal regulators in permitting banks to assume significant and unfamiliar risks. The need to protect the continued viability of federal deposit insurance funds alone would seem to require such oversight. It seems clear that the discipline of the marketplace alone will not assure the public of the kind of stable banking system it demands.

Glass-Steagall Considerations

A brief analysis of the rationale underlying the Glass-Steagall Act suggests additional policy considerations that must be taken into account as the prospect of bank deregulation is weighed.

As discussed above, commercial banks occupy a pivotal position in our economy, and public confidence in banks' ability to perform their essential functions is imperative to the efficient operation of American business. In the wake of the stock market crash of 1929 and the ensuing Depression, Congress determined, on the basis of exhaustive hearings, that the importance of banks in the economy was so great, and the conflict between commercial banking activities and securities activities so overwhelming, that commercial banking had to be walled off from investment banking and most other securities activities.

The salient underpinnings of the Glass-Steagall Act were aptly set forth by the U.S. Supreme Court in ICI v. Camp

(401 U.S. 617 (1971)). There the Court noted that the hazards Congress had in mind when it enacted Glass-Steagall were not limited to the "obvious danger that a bank might invest its own assets in frozen or otherwise imprudent stock or security investments," but also included certain "more subtle hazards" that arise from the relationship between a commercial and investment banking business. For example, the Court pointed out that:

(1) Because a bank and its affiliates are closely associated in the public mind and because public confidence is essential to the solvency of a bank, the bank might be tempted to "shore up the affiliate through unsound loans or other aid" if the affiliate should fare badly.

(2) The bank salesman's interest in selling a particular investment and making its security affiliate successful might impair the bank's ability "to function as an impartial source of credit" and the bank might make its credit facilities more freely available to companies in whose securities the affiliate had invested "or become otherwise involved."

(3) Bank depositors might suffer losses on securities purchased in reliance on the relationship between the bank and its affiliates and the resulting loss of customer goodwill might become a handicap to the bank.

(4) The promotional nature of investment banking might lead commercial banks to "lend their reputation for prudence and restraint" to the selling of particular securities and that this could not be done without the bank's reputation being undercut by the "risks necessarily incident to the investment banking business."

(5) Commercial banks would be tempted to make loans to customers to facilitate the purchase of securities promoted by the bank or its affiliate.

(6) The promotional interest of the investment banker and the obligation of the commercial banker to render disinterested investor advice conflict and raise the related concern that banks and their affiliates might unload into the trust department of the bank securities they were unable to sell otherwise.

In conclusion, the Court stated that:

> ...Congress acted to keep commercial banks out of the investment banking business largely because it believed that the promotional incentives, of investment banking and the investment banker's pecuniary stake in the success of particular investment opportunities was destructive of prudent and disinterested banking and of public confidence in the commercial banking system.

These hazards are no less real today than they were in 1933 and have relevance to bank entry into any commercial endeavor.

A review of the 1981 and 1982 hearings regarding S. 1720 and other related bills is enlightening. The principal arguments presented in support of the revocation of the Glass-Steagall Act were (i) that the legislation was enacted 50 years ago, and (ii) that various statutes enacted in the intervening years (*e.g.*, federal securities laws, ERISA, and other banking legislation) constitute a system of government regulation able to protect depositors and investors from abuses such as those preceding Glass-Steagall.

The passage of time may warrant a *reassessment* of the Glass-Steagall Act, but, by itself, it is hardly a convincing argument for an *elimination* of that Act's protections. As to the intervening legislation, much of it assumed that the Act itself could eliminate certain fundamental problems. Thus, more recent statutes have appropriately been able to ignore those problems altogether.

Even with the Glass-Steagall Act prohibitions, the federal securities laws, ERISA, and other extant systems of regulation, banks, secure in the realization that the federal banking regulators will not require them to disclose embarrassing transactions and problems, have too often permitted conflicts of interests to outweigh reasonable business judgment. The misfortunes of the banking industry with real estate investment trusts, New York City securities, repurchase agreements, and loans to relatives and business associates of controlling persons provide us with little confidence that either human nature or banking practices have changed sufficiently in the last 50 years to warrant wholesale tampering with the constraints of the Glass-Steagall Act. While the systems of regulation mentioned do make unlawful some of the abuses that preceded the Glass-Steagall Act, they do not deal with the basic conflict of interest problems that Glass-Steagall was enacted to overcome. In 1933 Congress concluded that most of these problems were so fundamental that they defied regulation and that the only answer was to prohibit commercial banks from participating in investment banking and other securities activities. Until some demonstration can be made that these fundamental problems have been adequately dealt with, we believe that the Glass-Steagall Act should remain in place and should receive interpretation by the courts and regulatory authorities that will adequately provide the protection that the statute was intended to confer.

BANKING AND INSURANCE

Nowhere are the reasons for separating banking and commerce more apparent than in connection with the business of insurance. Assuming high risks is not an activity in which most depositors would want to see their banks engage, yet risk assumption is the predominant activity of the life insurance business.

State Enabling Legislation

Recently the American Bankers Association commissioned a study by a prominent consulting firm to evaluate the types of commercial activities that would be appropriate and advantageous for banks in a deregulated environment. Many different types of activities were considered including securities brokerage, insurance, real estate and travel agency. The study concluded that insurance underwriting is the least desirable of all activities -- a low-profit, high-risk business which does not mesh favorably with banking.

These somewhat unflattering views, however, have not been given much prominence by the bank lobby in the various state capitals where insurance powers are now being sought for state depository institutions. The South Dakota legislature, in early March, enacted a measure sponsored by several money center bank holding companies (and promoted, incidentally, as a jobs bill) which allows a state chartered bank to engage in "all facets of the business of insurance" either directly within the bank or through a subsidiary. This measure also permits South Dakota banks to be acquired by out-of-state entities, such as money center bank holding companies. It should also be noted that this new law operates to constrain the insurance operation of a South Dakota bank from selling insurance to residents of South Dakota, although sales in all other jurisdictions are expressly permitted.

Similar legislation has been proposed or is under consideration in a number of other states, most notably Delaware.

The intended purpose of this exercise is as transparent as it is inappropriate -- to circumvent the clearly expressed intent of Congress in Title VI of the Garn-St Germain Act relating to the treatment of insurance activities under the Bank Holding Company Act.

Under the Act, insurance is categorized as a "nonbanking activity" which bank holding companies and their subsidiaries may conduct only in very limited fashion. The theory underlying the South Dakota legislation is that by defining insurance as a "banking activity" in South Dakota, holding companies acquiring South Dakota banks will not be subject to the Act's nonbanking restrictions. The same theory, if it succeeds in this instance (and most assuredly it will be tested administratively and, if necessary, in court) would appear to permit state chartered banks, including those that are part of a holding company complex, to underwrite securities or manufacture automobiles or operate gambling casinos. More disturbing, if allowed to succeed, such legislation will signal that the control of the national banking system is no longer in the hands of the Congress and the federal banking regulators responsible to the public for the safety and soundness of that system.

Other Specific Considerations

There are, in addition to the areas previously discussed, a number of specific reasons for the Committee to be concerned about the integration of banking and insurance.

Solvency. For some time banking regulators have been concerned about the thin margin of capitalization in the banking system. This official worry is, of course, accentuated by the large share of bank liabilities that is either short-dated or payable on demand.

The current demands of the banking industry for authority to enter a sharply expanded range of financial service markets consequently creates added concerns among regulators about the adequacy of bank capital.

As noted by Federal Reserve Board Chairman Volcker in his recent testimony before this Committee, it is well nigh impossible to insulate completely from one another the various activities of a single organizational entity. The fortunes of one activity invariably influence the fortunes of the others.

Simply stated, where banking and insurance are conducted within the same legal entity, customers of its commercial and insurance departments will each be faced with unbargained-for risks. The life insurance industry feels very strongly that when consumers purchase life insurance products, they should not have the security and the protection afforded them by those products imperiled by unsound banking practices. I would suspect that commercial banking customers would agree that the converse is equally undesirable. Yet this is precisely the result that can be expected under the South Dakota law and similar state proposals now under consideration.

There are, of course, safety mechanisms in existence designed to protect consumers from institutional insolvency -- such as the federal deposit insurance for banks and, in many states, guaranty associations for insurers. In the past, these mechanisms have worked quite well and have adequately protected the constituencies they were designed to serve. These protective mechanisms may well be jeopardized by the South Dakota approach to integrating financial services.

Should the FDIC be responsible for paying off depositors of a bank which has failed due to the catastrophic losses incurred by its insurance department? Or, should state guaranty associations be used to satisfy insurance contracts written by the insurance department of a bank which has been drained of its revenues to cover losses occasioned by imprudent loan policies of the bank? Surely not. These are risks against which the respective safety mechanisms were neither intended to protect nor fund.

It is also likely that the administrators of the state insurance guaranty associations will have serious reservations about extending coverage to policyholders of the insurance department of a bank. Similar concerns might be raised by the FDIC. The consumer would be the ultimate loser in the event of any dispute over the application of these safety mechanisms.

In sum, the ability of a depository institution to conduct an insurance business through a department of that institution gives rise to a corporate structure that may threaten the solvency of both enterprises. In addition, such an arrangement is inconsistent with the purposes for which banking and insurance guaranty mechanisms were established.

Regulatory Conflicts. While the insurance business is regulated to some extent by federal agencies, it is primarily and comprehensively regulated by the states. Thus, the integration of insurance and banking, especially in the direct fashion contemplated by South Dakota law, is likely to result in a series of turf battles and conflicting regulations among the competing governmental authorities. We have already heard several federal bank regulators suggest that allowing banks to underwrite insurance might be an acceptable proposition if the regulation of the insurance function could be placed in their hands.

The fact that insurance is primarily state regulated has gone largely unrecognized by many of those who would reshape the financial services industry. A case in point is the Bush Task Group on Regulation of Financial Services. In the initial release creating the Task Group, insurance was mentioned several times as a proper subject for concern. Yet, unlike all other financial service areas, the insurance industry has no regulatory representative on the panel. The same lack of recognition and understanding of state insurance regulation is reflected in the Treasury's proposal for deregulation discussed below. Insurance is an integral part of that proposal, but I can assure you that it was not structured with the benefit of any input from the insurance regulators.

Mr. Chairman, we are pleased that at least your Committee has not forgotten the relevance of state insurance regulation. The Committee has already heard testimony in these proceedings from the National Association of Insurance Commissioners. We hope others will follow the example of the Committee and allow the full participation of the NAIC in future discussions on these topics.

Tie-in Sales. When individuals or businesses come to a bank seeking extensions of credit, they often come with hat in hand. They need that money, and often they know that a denial of credit can have dire consequences. Quite understandably in such circumstances, people are susceptible to the suggestion, expressed or implied, that they may be more likely to get a loan if they agree to purchase additional bank services.

The fear that banks will use the leverage of their unique lending power to encourage the sale of nonbanking services has been echoed by many of the witnesses before this Committee as well as some of the Committee members themselves.[*/] Insurers

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[*/] "There is ample evidence that coercive tie-ins are deeply rooted in traditional banking practices;" excerpt from floor speech of Senator Edward Brooke during debate on the Bank Holding Company Act Amendments of 1970, Congressional Record, 5/11/70.

"Because of the inferior bargaining position of the debtor, he may be susceptible to the loan officer's 'suggestions' concerning choice of coverage, premium rates, insurer and agent. As a result, the debtor easily may receive the impression that his loan application may be more favorably considered if he follows such suggestions." Testimony of Federal Reserve Board at hearings on Consumer Credit Insurance Act of 1969 (S. 2764) before the Subcommittee on Financial Institutions of the Senate Banking Committee, 91st Congress, 1st Session, 163 (1969).

have better reason than most to express such a concern. There is a substantial record of testimony before this Committee, not only this year but in years past, to indicate that tie-ins by banks between extensions of credit and the sale of credit life and disability insurance are commonplace. The Federal Reserve Board's own study of this area indicated that nearly two-thirds of bank borrowers purchase credit life or credit health insurance. And over 40 percent of those who purchase such insurance do so because they believe it is "required" or "strongly recommended."[*] How many more agree to purchase such insurance simply because they believe that it can't help but improve their chances of getting a loan?

How much more pressure will there be when the array of nonbanking services also includes life insurance, auto insurance, homeowner's and so on?

We have all heard the banks endeavor to counter this argument by stating that they do not engage in tie-ins because they are illegal. And so they are. But prohibiting tie-ins and preventing them from occurring are two very different propositions. And it is the effective prevention of tie-ins that has received very little consideration in the current debates over the further expansion of bank powers.

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[*] "Tie-Ins Between the Granting of Credit and Sale of Insurance by Bank Holding Companies and Other Lenders;" Federal Reserve Board Staff Study, Eisenbeis & Schweitzer (1979).

It is at least arguable that because of the importance of their lending powers, banks occupy such a unique position that the mere offering of other services is inherently coercive. If this is so, and we submit that the argument deserves your very careful study, then no amount of restrictive legislation can fully remove this unfair advantage.

Treasury Proposal. Mr. Chairman, I would like to comment briefly on the proposal for financial service deregulation which we understand will again be advanced by the Treasury. The Treasury proposes to insulate banks against the pyramiding of risks by requiring that any new financial services be offered through subsidiaries of a bank's holding company. At least in theory, this would appear to be an improvement over the South Dakota approach of permitting the bank to conduct the new service directly. However, in practice bank holding company structures are frequently dominated by the commercial bank subsidiary, resulting in the holding company being equated in the public mind with the bank itself. For this reason, major banks are likely to be reluctant to let their holding company subsidiaries falter. Ample evidence of this pattern of activity surfaced in the 1970s when bank REITs encountered difficulties and financial assistance was often channeled from the bank to the REIT to try to keep the latter afloat.

This close public identification of holding company subsidiaries with the primary commercial bank in a holding company system raises the serious question of whether the Administration's plan for bank deregulation will really achieve the effective insulation of the bank from the risks assumed by the holding company or its nonbank subsidiaries.

Further, the Treasury's proposal does not address the potential regulatory conflicts that would be created between state and federal officials nor does it deal effectively with the problems of self-dealing and tie-ins. Significantly, the proposal would not permit mutual insurers who, represent a major segment of our business, to participate fully in expanded financial service operations. In fact, virtually none of the concerns which we raised last year concerning the Treasury's deregulation proposal have been addressed.

It is therefore fitting that the portion of our testimony (delivered before Senator D'Amato's Securities Subcommittee on February 12, 1982) detailing our objections to that proposal be resubmitted as an appendix to this statement.

REMEDIAL LEGISLATION

The haphazard integration of financial service intermediaries now occurring obviously cannot be laid at the feet of the depository institutions alone. Bankers, thrifts, securities companies, and insurers have all mounted expeditions to the far reaches of existing law and beyond in an effort to see how many different financial services can be aggregated within one company or within one corporate complex.

In one sense, this behavior is understandable, since no one wants to be the last to avail themselves of a perceived competitive advantage. So long as legislators and regulators leave the avenues to these real or imagined advantages open, all offerors of financial services -- and certainly this would include members of our own industry -- will be scrambling to acquire still more services by whatever means available. We believe this is the least desirable way to achieve change in an area so fundamentally vital to the Nation's economic well being.

In testimony before this Committee, Treasury Secretary Regan and Federal Reserve Board Chairman Volcker called for immediate Congressional action to halt the undirected and increasingly chaotic financial services deregulation process and, in so doing, afford Congress the time to develop a more fair and orderly approach to financial service deregulation.

The Federal Reserve Board has been actively involved in developing the concept of a legislative moratorium that would temporarily close the various avenues for integrating banking with other commercial activities such as insurance and securities brokerage. Given the frenetic pace of legislative, regulatory and industry initiated activity in this area, we endorse the concept of a legislative moratorium as a means of providing Congress with the opportunity to review carefully the many important issues involved.

It is my understanding that the moratorium, as presently conceived by the Federal Reserve Board, would address three avenues of financial services integration: nonbank banks, state enabling legislation (e.g., South Dakota) and thrift institutions. While this organization does not have existing policy permitting it to take a position on that portion of the moratorium dealing with thrift institutions, we do endorse the moratorium in all other respects. As to thrifts, our policymaking bodies are scheduled to meet within the next few days to address this issue, and I will be happy to advise the Committee of the results of their deliberations.

Whether or not Congress enacts a broad moratorium, we believe that some action must be taken to prevent the circumvention of Title VI of the Garn-St Germain Act as has been recently attempted in South Dakota. Attached to our statement for the Committee's consideration is proposed legislation which would amend the Bank Holding Company Act to make it clear that state bank subsidiaries of bank holding companies may engage in insurance activities only to the extent permitted under Section 4(c)(8) of the Act.

As Treasury Secretary Regan noted in his remarks before this Committee, the South Dakota legislation is unfortunately likely to be just the beginning of a race by the states to see who can regulate banking the least. By enacting the amendment to the Bank Holding Company Act which we have proposed, Congress will be able to retain the flexibility to oversee the changing financial services industry despite the legitimate exercise of state legislative prerogatives, while giving full meaning to the provisions of Title VI of the Garn-St Germain Depository Institutions Act of 1982.

Mr. Chairman, that concludes my prepared remarks. I want to thank the Committee once again for the opportunity to testify. I will be happy to answer any questions the Committee may have.

STATEMENT OF THE
AMERICAN COUNCIL OF LIFE INSURANCE

Before the
SUBCOMMITTEE ON SECURITIES
of the
SENATE COMMITTEE
ON
BANKING, HOUSING, AND URBAN AFFAIRS

on

THE BANK HOLDING COMPANY DEREGULATION ACT
OF 1982

February 12, 1982

Statement made by:

Horace R. Baker, Jr.
Senior Vice President
and Secretary
John Hancock Mutual Life
Insurance Company
John Hancock Place
Boston, Massachusetts 02117

Mr. Chairman and members of the Subcommittee. My name is Horace R. Baker, Jr., Senior Vice President and Secretary of the John Hancock Mutual Life Insurance Company, and I am appearing on behalf of the American Council of Life Insurance. I am accompanied by Gary E. Hughes, Chief Counsel, Securities of the American Council of Life Insurance. The Council has a membership of 529 life insurance companies that represent 97% of the total assets of all United States life insurance companies and U.S. branches of Canadian companies. We are grateful for this opportunity to comment upon a draft bill prepared by the Treasury Department entitled the "Bank Holding Company Deregulation Act of 1982" (the "Administration Proposal"). This bill reflects the Administration's views on the manner in which depository institutions should be permitted further entry into the businesses of securities, insurance, real estate and other financial service activities.

The primary focus of the Administration Proposal is on the facilitation of banks' entry into the securities business. However, the proposal does contain other very significant provisions, including Section 11, which would specifically empower bank holding companies to engage in insurance underwriting and brokerage. We recognize that the hearings of this Subcommittee are intended to explore issues associated with the proposed securities activities of banks. While we address these issues in some detail, we do feel it necessary to express as well some views regarding the matter of banks' entry into the business of insurance.

Proposed Bank Securities Activity

The Administration Proposal as presently drafted would require banks wishing to engage in the underwriting of municipal revenue bonds or the underwriting of mutual fund shares to establish, under the umbrella of a bank holding company, a securities affiliate through which these activities would be conducted. The securities affiliate would be subject to regulation by the Securities and Exchange Commission in the same manner and to the same extent as any other securities firm not affiliated with a bank. In our view, the concept of equal regulation as among financial institutions as reflected in the Administration Proposal is an improvement over the disparate regulatory scheme envisioned by Title III of S.1720.

The federal securities laws are the rules by which those wishing to engage in the mutual fund business must abide. It has been so for the better part of fifty years. In its testimony on S.1720 last October, the Council objected strongly to the fact that Title III of that bill would permit banking institutions to underwrite the shares of any mutual fund, whether or not sponsored by a bank, without being subject to the comprehensive regulatory provisions of the Securities Exchange Act of 1934. Whether or not one agrees with all the aspects of broker/dealer regulation, it is, under the present scheme of the law, a prerequisite to the offering and sale of mutual fund shares. Exception from this regulatory pattern has not been extended to financial institutions which are otherwise regulated and which might find it more desirable to underwrite fund shares without compliance with the Exchange Act or with an agency other than the SEC administering that Act. Compliance with the Exchange Act by life insurance companies engaged in the underwriting of mutual fund shares through their affiliates or subsidiaries is testimony to this fact.

The Exchange Act imposes certain obligations on the mutual fund underwriter. The more significant of these obligations include, among other things, the formation and registration of a broker/dealer and the associated ongoing reporting and compliance duties. In addition, all the individuals involved in the underwriting activity must be trained and qualified as securities principals or registered representatives. While the significance of these burdens varies from company to company depending on a number of facts and circumstances, the burdens must nonetheless be assumed by anyone desiring to enter the business. Any other result would constitute disparate regulation, and disparate regulation results inevitably in unfair competition. To permit banks to enter the mutual fund business and enjoy a competitive advantage by not having to comply with the provisions of the Exchange Act would be unwarranted and totally indefensible. If there were any sound justification for the unequal regulatory treatment envisioned by S.1720, we feel certain its proponents would have taken great care to point out that justification to Congress and competing financial institutions. The record is devoid, however, of any rationale offered up in support of that bifurcated regulatory approach.

The Exchange Act as well as other provisions of the federal securities laws from which banks would be exempt under the provisions of S.1720 provide many essential protections to the investing public. For example the Exchange Act subjects the mutual fund activities of broker/dealers to "suitability" and "know-your-customer" rules. These rules place an affirmative obligation on broker/dealers to know their customers and recomend only suitable investments. The importance of these rules becomes clear when one remembers that S.1720 would permit depository institutions to underwrite, in addition to money market funds, all types of mutual funds with varying degrees of risk and varying investment objectives. It is difficult to dispute the fact that venture capital funds, foreign investment funds and other potentially speculative investments are not suitable for everyone. Consequently, the protections of the suitability and know-your-customer rules are no less important to bank customers as they are to the customers of competing institutions.

Similarly, broker/dealer sales personnel are subject to character requirements and competency standards designed to prevent participation in the marketing of securities by dishonest and incompetent individuals and persons insufficiently educated concerning the products and markets with regard to which they perform such an important function. The SEC has both civil and administrative rememdies available to enforce these provisions.

Finally, and perhaps most important, the federal securities laws impose advertising, disclosure and anti-fraud rules upon broker/dealers and investment advisers. Both statutory and implied rights of action against broker/dealers and investment advisers derive from these rules and constitute a significant form of investor protection.

In structuring a regulatory system that will assure competitive equality, it is absolutely essential that a single regulator be charged with the responsibility for administering the applicable laws. The presence of more than one regulator would inevitably lead to differing interpretations of identical laws. This in turn would result in unequal regulatory treatment of competing institutions, making fair competition impossible.

In summary, we submit that the regulatory protection given to investors in mutual funds should not vary depending upon which financial institution underwrites the particular mutual fund they purchase, and that no type of financial institution should enjoy a competitive advantage by being able to underwrite such securities under a less burdensome regulatory structure than that applicable to its competitors. The present Adminstration Proposal embodies these principles in a satisfactory fashion by making bank securities affiliates subject to the federal securities statutes in the same manner as any other securities firm. This is a marked improvement over S.1720. If the Congress should, however, determine that any of the protections provided by the securities statutes are unnecessary to investors purchasing mutual funds from banks' securities affiliates, the same treatment should be afforded to banks' competitors in the mutual fund business.

Proposed Bank Insurance Activities

We recognize that the bank securities affiliate concept is just one portion of the Administration's proposal to deregulate the banking industry and financial services generally. The life insurance business has an obviously strong interest in the regulation or deregulation of the financial services industry, and particularly so where the proposal contemplates a broad expansion of bank powers in connection with insurance.

The life insurance business wishes to stress that it is in no way opposed to increased competition. In fact, as our previous testimony on S.1720 before the Senate Banking Committee indicated, life insurance is a highly and increasingly competitive business. Our concern lies not in the prospect of increased competition but rather unfair competition. A so-called "level playing field" is not established merely by allowing everyone into everyone else's business. With regard to bank insurance activities in particular, a number of complex problems have arisen which must be satisfactorily resolved before this aspect of bank deregulation can proceed in a fair and orderly manner.

It is vital that the issues raised by the Administration Proposal be the subject of full hearings in the appropriate forums. We would expect the sections of the bill affecting the business of insurance to be fully aired in hearings before the Senate and House Commerce Committees, which, as you know, have had jurisdiction over insurance matters. However, at this time it seems appropriate for us to offer a brief first reaction to the sections of the Administration Proposal directed at increasing the insurance activities of bank holding companies.

Under Section 11 of the Act, bank holding companies, through the use of subsidiaries, are permitted to engage in insurance activities without limitation and without prior approval.

Section 13 would allow the Federal Reserve Board, under certain circumstances, to examine the books and records of insurance companies owned by bank holding companies. Since the internal affairs of insurance companies are now regulated exclusively by the states, such a provision would most certainly create a conflict between regulators.

These sections suggest a number of other problems to us as well:

1) Historically, because of the leverage connected with their unique commercial lending power, banks have been able to convince their credit customers that it is in the customer's best interest to use other services offered by the bank such as credit life and health insurance. We realize that this is not a revelation to most of the members of this Subcommittee. The Senate Banking Committee has often taken notice of this economic fact-of-life in committee reports on bills intended to limit the insurance activities of bank holding companies. Such bills passed both Houses of Congress in the 95th and 96th Congress. As noted by Senator Brooke in 1970 hearings:

"There is ample evidence that coercive tie-ins are deeply rooted in traditional banking practices."[1] These tie-in activities hamper competition by eliminating product quality and price as considerations in the consumer's purchasing decision. In the process, non-bank industries such as insurance and small businessmen such as life insurance agents are injured as well.

The Federal Reserve Board has acknowledged this problem on occasion,[2] but has as yet been unable to resolve it with regard to the limited number of non-bank services now offered by banks. Unless an effective deterrent to this sort of activity can be found, the further entry of banks into insurance and other non-bank areas will only serve to exacerbate the problem.

2) Under the current proposal there is an unequal benefit in allowing banks and insurers into each other's business. A small insurer, typically licensed to do business in most states, which has been acquired by a large bank can be leveraged relatively easily into a substantial enterprise. A similar situation does not result from the acquisition of a small bank by a large insurer for the simple reason that there is nothing to leverage.

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[1] Excerpt from floor speech by Senator Edward Brooke during debate on the 1970 Amendments to the Bank Holding Company Act, May 11, 1970.

[2] "Because of the inferior bargaining position of the debtor, he may be susceptible to the loan officer's "suggestions" concerning choice of coverage, premium rates, insurer and agent. As a result, the debtor easily may receive the impression that his loan application may be more favorably considered if he follows such suggestions." Testimony of Federal Reserve Board Hearings on Consumer Credit Insurance Act of 1969 (S.2764) before the Subcommittee on Financial Institutions of the Senate Banking Committee, 91st Congress, 1st Session, 1963 (1969).

3) Mutual insurance companies are owned by their policyholders rather than by stockholders. As a result, unlike stock companies, mutuals cannot be owned by an upstream parent company (i.e., a bank holding company). Under the terms of the Administration Proposal, it is only through the medium of the bank holding company that banks and insurers can exist under the same corporate umbrella. Thus, mutuals, which constitute some of the largest financial institutions in the country and are a major segment of the life insurance business, would likely be precluded from participating in the intended benefits of the Administration Proposal. This would create a competitive imbalance between different types of insurers now enjoying relative competitive equality under the existing law.

4) Administration officials have indicated to us that they regard insurance as a relatively unregulated industry into which a newly deregulated banking industry could easily and naturally blend. We do not understand this comment at all. In fact, virtually every aspect of insurance is subject to comprehensive regulations at the state level. In many cases the goal of bank deregulation on the one hand and legitimate state insurance regulations on the other may seriously conflict. For example, in some states there are existing statutory prohibitions against insurers owning banks.

We are not aware of any contact having been made by the drafters of Section 11 with state insurance regulators. If serious consideration is to be given to the Administration Proposal, state insurance officials must be consulted at the earliest opportunity.

We have discussed a number of these concerns with Administration officials and have been told in effect that the most important thing is to deregulate as soon as possible; the problems can be solved later.

We are also aware that there is some sentiment in the Congress to go forward with bank deregulation now. No more studies; no more delays. The concerns we have raised, however, are not theoretical or argumentative, they are real; and they are not capable of being solved post deregulation.

Deregulation should not be thought of as an end in itself but rather as a means to increased competition and better service to consumers. We believe that to achieve those ends will require a more thoughtful and thorough approach than that which has been put forth in the current Administration Proposal. However, we would be delighted to work with the Committee, the Treasury or any other appropriate group to find ways to address these concerns. Thank you.

ACLI DRAFT
4/19/83

BANK HOLDING COMPANY ACT OF 1956

Amendment to Prevent Circumvention of Non-Banking Restrictions Through Banking Subsidiaries

Section 3 of the Bank Holding Company Act of 1956 (12 U.S.C. §1842) is hereby amended by adding to that Section a new Subsection (f) to read as follows:

Prohibitions

(f) "No bank that is a bank holding company and no bank that is a subsidiary of a bank holding company may directly or indirectly engage in any activity that is prohibited under Section 4 of this Act."

Explanation

Under Section 4(c)(8) of the Bank Holding Company Act, as amended last year by Title VI of the Garn-St Germain Depository Institutions Act, insurance is a "non-banking activity" which bank holding companies and their subsidiaries may conduct only in very limited fashion. Recent legislation in South Dakota attempts to circumvent that limitation by defining insurance as a "banking activity" when conducted by a South Dakota bank. Thus a holding company acquiring a South Dakota bank with an insurance operation would arguably not be subject to the 4(c)(8) restrictions on non-banking activities.

The above proposal would amend the BHCA to make it clear that state bank subsidiaries of bank holding companies may engage in insurance activities only to the extent permitted under Section 4(c)(8) of the Act.

The **Chairman**. Thank you.

Mr. Suttle.

STATEMENT OF WILLIAM W. SUTTLE, SENIOR VICE PRESIDENT FOR FEDERAL AFFAIRS, AMERICAN INSURANCE ASSOCIATION

Mr. **Suttle**. Mr. Chairman, thank you. It is a distinct privilege to appear before this body this morning, especially with my distinguished colleagues, including the former Senator and Secretary. The last time I sat at this table a gentleman from Alabama, Mr. Sparkman, was in your position, so I'm a bit rusty. I can't be as eloquent as the Secretary, but I shall proceed and do my best.

As a group, the members of this panel represent companies which provide more than one-half of all the private insurance coverage in this country. My organization is the American Insurance Association. Our 164 member companies have annual written premiums in excess of $30 billion or slightly more than 31 percent of the total market for property-casualty insurance in this country. The investment portfolios of our companies total more than $50 billion. So we obviously have a very real and sincere interest in the structure of the American financial services industry, both as it is today and as it will be in the future.

The specific areas of interest outlined in your May 18 letter, Mr. Chairman, are particularly significant. In the time allotted this morning, I will try to address some of those issues and certainly be more than happy to respond to the committee's questions. The document which we have filed with the committee is a more thorough discussion of the concerns and positions of our association and we appreciate this opportunity to make all of this a part of your record.

Your letter and previous witnesses expressed interest and concern about the structure and the powers of various depository and other components of the financial services industry. We share that concern and especially at this time. It is particularly disconcerting to our members that both the structure and the powers of deposit-taking institutions are being significantly modified. Changed not by the Congress nor with thoughtful deliberation about the consequences, but changed through the pursuit and enactment of state banking laws that would serve limited special interests and circumvent well-established federal policy.

IMPACT OF THE SOUTH DAKOTA LAW

We're all well aware that on March 4, 1983, South Dakota enacted a law specifically authorizing that State's banks to engage in all facets of the insurance business. That legislation permits State-chartered banks to conduct that business directly within the bank rather than through a subsidiary. The rationale was simple, even if not wise. To conduct the insurance business within a subsidiary would make the bank a holding company and therefore render its insurance activities unlawful as specifically prohibited by the Bank Holding Company Act, a prohibition reaffirmed as recently as last year when you, Mr. Chairman, and the 97th Congress enacted the Garn-St Germain amendments to the Bank Holding Company Act.

As imaginative as this interpretation of the Bank Holding Company Act may be, it is difficult to believe that Congress enacted comprehensive legislation in 1956 to regulate bank holding companies with the intent that the actions of a single State could render it moot. The plain language and the legislative history of the act indicate clearly that the nonbanking restrictions apply not only to bank holding companies and their nonbanking subsidiaries but also to every banking component, whether state or federally chartered.

A similar proposal for State action is under serious consideration in Delaware and others are being discussed in still more jurisdictions.

Almost as disconcerting as the South Dakota law and other State proposals are the reasons being given for them. Governor Janklow hailed the South Dakota law as a solution to his State's unemployment problem. Delaware proponents offer their legislation as a way to stimulate the "first State's" economy while allowing it to become the Nation's new financial capital.

There may well be sound reasons for relaxing the restrictions on the activities of deposit-taking institutions, but we submit that reducing a State's unemployment rolls or creating a new financial capital are not sound rationales for gutting a Federal and State regulatory scheme that has performed reasonably well for more than half a century. Most certainly, passing some crazy quilt pattern of State laws based on such reasoning can only produce bad law. South Dakota's law is an excellent example of what may happen unless the Congress restores order and uniformity to the system.

Like the committee, our concerns go beyond the changing structures and power of deposit-taking institutions and encompass the many regulatory problems that may evolve from combining banking and insurance activities. We wonder, in these times of numerous insolvencies and related problems within deposit-taking institutions if banking and insurance regulators will be able to adequately supervise hybrid entities containing two highly cyclical activities. For reasons as essential as protecting the funds of depositors and maintaining the solvency of insurers, banks and insurance companies have different accounting standards and procedures. Furthermore, each has a different investment mandate.

It would be impossible in the time allowed to address all potential regulatory problems and conflicts that could arise from combining the functions of banking and insurance, but certainly any ability to commingle assets associated with the insurance and banking business would undoubtedly cause major problems for both the insurance and the banking regulators.

Perhaps this was even recognized by proponents of the new South Dakota law because, as my distinguished colleague, Mr. Schweiker has pointed out, their newly authorized banking insurance entities are permitted to offer their products and services only outside the State of South Dakota. That I'm sure is no doubt small comfort for the regulators in other states.

REGULATORY PROBLEMS AND CONFLICTS

At this point, all could probably agree that regulatory problems and conflicts are probable. Many were enumerated to you on May 20, 1983, when you heard from the groups representing several regulatory bodies, including the National Association of Insurance Commissioners. We contend that before the authority of any financial service industry is expanded to allow entry into any other highly regulated endeavor, the regulatory problems must be fully explored and resolved. They must be resolved by the Congress, with uniformity, with equity, and most certainly with competitive parity.

The demand for parity of competition brings me to one of the most important concerns of our members. We wonder, is it possible for banks and thrift institutions to enter the business of insurance without automatically having an unfair competitive advantage over the existing industry?

Banks are special. They are unique. They're special as a matter of law. They solicit deposits of consumers backed by the full faith and credit of the National Government in the form of the Federal Deposit Insurance Corporation. They are special in that they hold these depositors' funds in a fiduciary capacity and use them as a final source of credit and liquidity for all other institutions, public and private. Banks have access to the central bank and serve as the link between that final source of funds and the remainder of the economy.

Because of the uniqueness of banks and the special treatment they are afforded, they possess the opportunity to exercise leverage with many who must turn to them for credit. Those who support the authority for deposit-taking institutions to engage in insurance activities minimize the potential evils of credit leverage. They claim that prohibitions against tie-in sales would be sufficient.

Our members believe that it is not so simple. Our concerns were well articulated before a similar hearing of this committee in the 91st Congress. In deliberations on S. 1754 in 1969, a representative of the Federal Reserve Board recognized that, and I quote:

> Because of the inferior bargaining position of the debtor, he may be susceptible to the loan officer's' suggestions' concerning choice of coverage, premium rates, insuror, and agent. As a result, the debtor easily may receive the impression that his loan application may be more favorably considered if he follows such suggestions.

Although these 1969 hearings resulted in a 1970 prohibition against tie-in sales being added to the Bank Holding Company Act, the problems did not go away. Ten years later, in 1979, a staff study of the Federal Reserve Board indicated that, of the nearly two-thirds of bank borrowers who purchase credit life or health insurance from lending institutions, over 40 percent do so because they believe it is required or strongly recommended. Simply prohibiting direct tying action will not be enough so long as the mere offering of other services may be coercive. We submit that until and unless effective ways are found to deal with potential for credit leverage, parity of competition cannot be said to exist.

RECOMMENDING TEMPORARY MORATORIUM

Finally, Mr. Chairman, I could not conclude these remarks without briefly addressing ongoing activities relating to nonbank banks. Our association supports what we understand to be the concept of a recommendation recently made before this committee by Chairman Volcker for a short moratorium on the combining of thrift institutions or nonbank banks with nonbanking entities. We believe such a temporary moratorium would permit the Congress to make a thorough examination of the difficult and complex issues presented by the blurring of traditional roles among financial institutions.

In recommending that the committee pursue a moratorium for a specific period of time on certain activities by financial institutions, we recognize that several companies within the insurance industry are now taking legal advantage of some of the inconsistencies in the Bank Holding Company Act and the Federal Deposit Insurance Act. We believe that the great preponderance of the evidence points to the fact that nonbanking institutions have now turned to nonbank bank vehicles in search for competitive parity. The federally insured money market deposit accounts authorized by the Garn-St Germain amendments allowed the banks and thrift institutions to drain literally hundreds of billions of dollars from money market mutual funds. Nonbanking entities saw and pursued nonbank banks as one way to meet this competition. By so doing, they too could offer their customers money market rates with "free" Federal insurance.

While conceding that a moratorium like that propounded by Mr. Volcker might impact on some of our members, we are convinced that support for a moratorium is only consistent with our contention that the Congress must act deliberately. We also understand that such a moratorium would remove pressures created by precipitous State action.

In summary and conclusion, as a staff officer of a large insurance trade association, my inclination might be to tell you that restrictions imposed on deposit-taking institutions in 1933 and thereafter continue to work well and that change is neither necessary nor desirable. However, the members of the American Insurance Association recognize changing consumer needs for financial services. Indeed, as I mentioned, some of our members are actively responding to these new consumer demands. Still, we contend that the issues which must be addressed are many and complex. Answers must be arrived at only after complete and thorough deliberation. Changes, if any are to be, must come in the public interest. They should come from the Congress, reflect uniformity, and maintain a competitive marketplace for all involved.

We will be more than happy to work with the committee as it seeks these solutions and I will be happy to respond to questions at the appropriate time. Thank you, Mr. Chairman.

[The complete statement follows:]

STATEMENT OF THE
AMERICAN INSURANCE ASSOCIATION

Mr. Chairman, members of the Committee, I am William W. Suttle, Senior Vice President - Federal Affairs, of the American Insurance Association. The American Insurance Association is a trade association representing 164 property-casualty insurance companies. The members of the American Insurance Association had written premiums of over $30 billion in 1981, which accounted for 31% of the market for property-casualty insurance.

The ongoing hearings before this Committee signify a growing awareness in Congress that changes taking place in the financial services marketplace have reached a critical point. We appreciate the opportunity to appear today and present our views on issues we believe are vital not only to the insurance industry but also to consumers who will be affected by the decisions of their elected officials.

These hearings are particularly timely because we believe they evidence an understanding within the Congress and among participants in these proceedings that when it comes to banking, the traditional cornerstone of this country's financial system, government must establish a single, uniform set of rules.

The last few months present a clear indication of what can happen when competitors in the financial services arena perceive loopholes in existing laws and regulations. As a result, some states, pursuant to the urging of certain bank holding companies, are moving to relax federal restrictions. These jurisdictions invite out of state bank holding companies to establish operations with the expectation that some collateral benefits, such as new jobs, may be gained. As laudable as such efforts to reduce local unemployment may be, these actions underscore the need for Congress to re-examine federal regulation of banking and, in the process, to make clear to the individual states that changes in the Bank Holding Company Act, if any are to be made, must be made with uniformity by the Congress and in the public interest.

We believe that the issues that must be addressed and the decisions which must ultimately be made demand an atmosphere where regulatory actions are not guided by the headlines of the day. Therefore, the American Insurance Association supports the suggestion made recently before this Committee by Federal Reserve Board Chairman Paul Volcker for a complete temporary moratorium on the combining of deposit-taking institutions with non-depository institutions. As we understand Chairman Volcker's recent testimony, this moratorium would bar combinations of thrift institutions or "non-bank" banks with non-banking institutions. We believe such a temporary moratorium would permit the Congress to make a thorough examination of the difficult and complex issues presented by the blurring of traditional roles of various financial institutions.

The changing needs of consumers in the financial services marketplace and the concomitant changes in the role of financial intermediaries, including insurance companies, is by now well known to this Committee and needs little, if any, review. The hearings of the Senate Banking Committee have quite properly focused on the need to take a thorough look at the role deposit-taking institutions play in our society and whether, in light of changing circumstances, the laws and regulations governing the permissible activities of such institutions should be relaxed. The primary question is: what role should banks and thrift institutions play in the new financial services marketplace?

As a staff officer of a large insurance trade association, my inclination is to tell you that the restrictions imposed on deposit-taking institutions in 1933 and thereafter continue to serve society well, and that change is neither necessary nor desirable. However, the members of the American Insurance Association recognize changing consumer needs for financial services. Indeed, some of our members are actively responding to these new consumer demands. We contend the issue which must be addressed is the need to balance the ongoing changes in the financial services marketplace with the unique and special role of banks and savings and loan institutions as providers of credit and caretakers of depositors' funds. If these traditional institutions were not deemed "special" as a matter of law, depositors would no longer be able to rely on guarantees from the federal government as to the safety of their money. The needs of consumers may change with the times or with technological advances; the "special" image of banks however, has not changed over the last 50 years.

The uniqueness of banks stems from their ability to meet deposit obligations under any conditions. The ability to rely on federal deposit insurance reinforces public confidence that the deposit obligations of these institutions contain a safety net shielding them from sudden drains of bank capital. This public confidence allows banks to attract consumer deposits. Banks hold these deposits -- the fruits of the labor and the investments of the American public -- in a special fiduciary capacity and use them to supply credit to the economy. This unique fiduciary role carries with it a special responsibility to the public.

Bank regulatory authorities and indeed, Congress, through its past actions, have fostered the notion that banks have a special responsibility to the public by requiring a separation between banking and other forms of commerce. The maintenance of this separation has been premised in no small part on the belief that banks may be called on to supply credit to borrowers who, for one reason or another, temporarily do not have access to other sources of funds. Therefore, it is essential that banks be in a position to make impartial and objective credit decisions. It has long been recognized by Congress that it is precisely at the time when banks must make impartial decisions as to which borrowers are experiencing problems of a fundamental or irreparable nature that the potential for compromise in the impartiality of the credit decision making process is greatest.

Recently, however, the traditional separation of banking from other forms of commerce has been called into question and in at least one state abolished. In the process of questioning this separation, deposit-taking institutions have attempted to portray a picture of being competitively disadvantaged by the products offered by other financial institutions, including insurance companies. At the same time, they obscure the fundamental distinctions between themselves and other types of financial institutions.

Let us now address a few specific issues that our Association believes must be resolved before the Congress can arrive at a realistic policy on relaxation of regulations for deposit- taking institutions.

State Legislation

Until March 1983, the Bank Holding Company Act of 1956 [12 U.S.C. 1841 et. seq.] made absolutely clear that once a company owned or controlled more than 25% of the voting shares of a bank, it became a bank holding company. As such, a bank holding company is prohibited from acquiring "direct or indirect ownership or control of any voting shares of any company which is not a bank." The purpose of the prohibition has always been to continue to keep banking separated from commerce.

Section 4(c) of the Act specifically enumerates situations in which the general prohibition against combining banking and non-banking activities does not apply. Principal among them is the exception that permits bank holding companies to engage in activities that are so "closely related" to banking as to be in the public interest. As recently as October 15, 1982, Title VI of the Garn-St Germain Depository Institutions Act of 1982, (Pub. L. 97-320) amended that exception by expressly prohibiting bank holding companies from engaging as an insurance underwriter, agent or broker in all but a few carefully spelled out exceptions.

On March 4, 1983, South Dakota enacted legislation that authorizes South Dakota banks to engage in "all facets of the insurance business." The legislation, which was promoted by Citicorp and other large out-of-state bank holding company interests, permits a state chartered bank to conduct an insurance business directly through the bank itself rather than through a subsidiary. The reason for conducting the insurance operations within the bank as opposed to within a subsidiary is to avoid the specific prohibitions of the Bank Holding Company Act.

Bank holding companies argue that a state can statutorily define "banking" very broadly to include, among other things, a full range of insurance powers and thereby avoid the federal law's limitations by acquiring a state-chartered bank having those expanded powers. Under this rationale, insurance activities must be conducted within the bank because if they should be done through a subsidiary, they would fall within the purview of the Bank Holding Company Act and thus be subject to the restrictions contained in the Garn-St Germain legislation.

As imaginative as this interpretation of the Bank Holding Company Act may be, it is difficult to believe that Congress enacted such comprehensive legislation in 1956 to regulate bank holding companies with the intent that the actions of a single state could render it moot. The plain language and legislative history of the Act indicate clearly that the non-banking restrictions apply not only to bank holding companies and their non-banking subsidiaries, but also to every banking component, whether state or nationally chartered.

The justification used by South Dakota in passing this legislation and in other states considering similar legislation, indicates just how difficult is the task that this Committee has before it. The South Dakota legislation was hailed by the Governor as an instant panacea for that state's unemployment problem. Similarly, the proposal being discussed but not yet introduced in Delaware has been presented by its proponents as a way to stimulate the state's economy while allowing Delaware to become the nation's financial capital.

There may very well be sound reasons for relaxing the restrictions placed on commercial activities of banks, bank holding companies and other financial institutions, but we submit that attempting to reduce one state's unemployment rolls at the expense of another or trying to become the nation's newest financial capital are not sufficient reasons to gut a regulatory system that has worked well for 50 years. Although circumstances have changed, the present regulatory system has evolved as a result of substantial accumulated experience. Passing a crazy quilt pattern of state laws based on such reasoning can only produce bad law. South Dakota's new law is an excellent example of what may happen unless the Congress restores order and uniformity to the system.

Regulatory Issues

One must wonder if the South Dakota legislature ever considered what might be the effect on the safety and soundness of that state's banks by permitting them to engage in "all facets of the insurance business" directly within the bank. If it had, the legislature might not have acted so quickly. It is one thing to pay lip service to the duty of regulating such an entity; it is another to actually perform the task of supervising an entity that combines two highly cyclical business activities within the same structure. On the other hand, perhaps the Governor and legislature were not concerned about such regulatory matters because the newly authorized bank/insurance entities are only permitted to offer their products and services outside of South Dakota. This is small comfort to the regulators of other states.

At a time when many banks are becoming insolvent and being forced to declare bankruptcy, how will state banking commissioners and state insurance officials be able to supervise some hybrid entity that uses different accounting standards for each activity and, by the nature of the business being conducted, requires different investment policies? The ability to commingle assets associated with the insurance and the banking business will undoubtedly cause major problems for both the insurance and the banking regulators.

The insurance industry has a well established system of state insurance guaranty funds providing protection to policyholders, claimants and the public against the inability of an insurer to meet claims as they come due. Most of these guaranty funds are managed on a post-funding basis wherein all remaining insurers are assessed after the insolvency of some other insurance company. In an integrated entity where both insurance and banking activities are being conducted, might not such an assessment place an insurmountable burden on the entity, particularly if the operating condition of the bank is impaired?

For over a quarter of a century, the business of insurance has been regulated at the state level. We believe that the regulatory mechanism for the insurance industry has worked very well, particularly when measured against the record of other industries. We commend this Committee for considering the concerns of state insurance regulators in your deliberations. We have noticed, however, that on a number of other occasions insurance regulators have not been requested to contribute their expertise to the debate on the future of the financial services industry and how it will be regulated. For example, although insurance is listed as one of the financial services to be studied by the Bush Task Force on the Regulation of Financial Services, so far as we have been able to determine, neither the insurance industry nor insurance regulators were asked to provide expertise to the group. Moreover, last year, the Chairman of the Securities and Exchange Commission, John Shad, suggested that Congress convene a blue ribbon commission to study whether changes were necessary in the regulation of the financial services industry. Most prominent by its absence from the panel of industries suggested for contributing expertise to the Commission was the insurance industry.

Credit Leverage - Economic Concentration

Beyond the basic questions related to regulating for solvency and the protection of depositors' funds, there is the very real potential that an entity which can sell or underwrite insurance and extend credit may well engage in unfair competitive practices which will ultimately decrease competition.

It is a well established fact that lending institutions have the capacity to control the decisions of many borrowers as to the source of insurance that they purchase in conjunction with extensions of credit. The Federal Reserve Board has recognized that

> Because of the inferior bargaining position of the debtor, he may be susceptible to the loan officer's "suggestions" concerning choice of coverage, premium rates, insuror and agent. As a result, the debtor easily may receive the impression that his loan application may be more favorably considered if he follows such suggestions.[1]

The Federal Reserve Board's acknowledgement that such a danger exists was underscored by Congress in its enactment of a prohibition against tie-in sales as part of the 1970 Amendments to the Bank Holding Company Act. The problem of potential tying arrangements, however, goes far beyond the overt coercive transaction. As the Federal Reserve Board's study indicated, of the nearly two-thirds of bank borrowers who purchase credit life or credit health insurance from the lending institution, over 40% do so because they believe it is "required" or "strongly recommended."[2]

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[1] Hearings on Consumer Credit Insurance Act of 1969 (S.1754) Before the Subcommittee on Financial Institutions of the Senate Banking Committee, 91st Cong., 1st Sess. 163 (1969).

As I indicated earlier, the maintenance of the separation between banking and other forms of commerce, including insurance, is rooted in the belief that banks, as suppliers of credit in situations where other segments of the credit market may be temporarily closed off, must be able to make impartial and objective credit decisions. Thus, the mere offering of other services must be considered to be potentially coercive. It seems self-evident that borrowers may view the purchase of bank-related insurance as being nothing more than a necessary evil to obtain and/or protect their credit.

Proponents of bank deregulation proclaim that if only banks were allowed to compete with other financial institutions, the problems of regulating for solvency, protecting against the use of unfair competitive advantages and all the other potential problems associated with combining banking and insurance could easily be resolved. It is ironic, however, that the call for relaxation of laws which have worked well for 50 years comes at a time when the public is being subjected to almost daily stories about the problems of the banking system, both within the United States and throughout the world.

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[2] "Tie-Ins Between the Granting of Credit and Sale of Insurance by Bank Holding Companies and Other Lenders;" Federal Reserve Board Staff Study, Eisenbeis & Schweitzer (1979).

At the same time that this Committee is being urged by bankers to authorize new activities, many of which are risky, Congress is also being lobbied to pass legislation increasing the lending authority of the International Monetary Fund. Could it be that some large bank holding companies think the losses many are suffering on their international loans can be made up by profits from insurance and other commercial business? There is something disconcerting about authorizing new activities to institutions that are having substantial problems fulfilling present obligations. How often have we read lately about another bank, be it in Tennessee or in Oklahoma, that has had to be closed by bank regulators after it was determined to be insolvent? It would be one thing if the cost of these insolvencies did not fall on taxpayers, but because of the federal deposit insurance guarantees, the public bears the cost of these failures.

Even those regulators who are the most ardent supporters of bank deregulation admit that there currently are problems in the banking system's safeguards. The Chairman of the Federal Deposit Insurance Corporation, William Isaac, has stated publicly that the bank regulatory system needs to be overhauled to make it more responsive to changes which have taken place in the financial system. His solution, however, is to allow banks to engage in a full range of financial activities, but institutions would be required to pay an insurance premium based on an assessment of how risky their activities are. In addition, he has proposed that current law be enforced and only the first $100,000 in deposits of an individual customer be given 100 percent insurance coverage. Deposits exceeding that amount would have a smaller percentage covered.

Judging by the volume of funds that have been switched from money market mutual funds to bank sponsored money market deposit accounts (MMDA) after the 1982 Garn-St Germain legislation was implemented, we find it difficult to believe that the public views banks and thrifts as just another place to park idle cash. If the public didn't recognize this special nature of banks, MMDAs with federal insurance would never have become as popular as they are.

In the June 1, 1982, report to the Chairman of the Federal Financial Institutions Examination Council, the General Accounting Office correctly observed that:

> The Congress and the financial institution regulators are being asked, in effect, to decide if the national policy of separating banking and commerce is still appropriate. Such a decision should consider whether currently permissible activities are having an adverse impact on the depository institutions' safety and soundness and whether the merging of banking and commerce is helping promote the economic and public benefits of the financial service industry.

After noting that sparse available data on the ancillary activities of banks and savings and loan associations suggest the possible adverse effect of such activities on the "safety and soundness" of the depository institutions, the report concludes:

> The regulators and the Congress do not have information needed to assess the impact of these activities and to formulate appropriate policies, legislation, and regulations directed at the merging of banking and commerce in the financial services industry as a whole.

Against this background of the uncertainty of the effectiveness of current banking regulations and the history of considerable abuse associated with credit life insurance, we submit that many questions remain unanswered relating to our serious concerns about the potential competitive advantages that "credit leverage" might produce from any combination of banking and insurance functions.

Treasury Proposal

During the course of similar hearings before this Committee in the 97th Congress and again in the testimony given recently before this Committee by Treasury Secretary Regan, the Administration has suggested that the cure for the increased risk to an institution engaging in both banking and other forms of commercial activity is to insulate one activity from another through the use of separate subsidiaries for each activity with an upstream holding company. Although this structure may be an improvement over South Dakota-type legislation, there are still flaws in this approach to deregulation. We subscribe to the logic of the testimony given recently before this Committee by Federal Reserve Board Chairman Volcker. The gist of his testimony was that the difficulties faced by a non-bank affiliate will in the end affect the bank itself. The price and availability of funds to the bank (or vice versa) may be affected by the problems of the non-bank affiliate.

An even bigger problem is the possibility that a sound bank in a holding company with a faltering affiliate might experience a run on its deposits. If the insolvency of United American Bank in Tennessee affected the solvency of five other independent banks, is it not also very possible that the problems of one part of a holding company system may cause the collapse of the entire structure?

The proposal put forth by the Department of the Treasury appears to include insurance among its list of activities for banks as an attempt to add symmetry to its proposal. However, the mechanics of how such a proposal would work have not been dealt with. For example, there appears to be a significant potential for regulatory turf battles between state and federal regulators and between banking and insurance regulators. The people likely to suffer in any such battles will be consumers -- those whom the relaxation of restrictions is supposed to benefit. In addition, mutual insurance companies may well be completely excluded from participating in the ownership of a bank unless they are willing to change their organization to a stock company. In short, the Treasury proposal appears to raise many questions for which answers are necessary before the ideas embodied therein can be given serious consideration.

Non-Bank Banks

In recommending that the Committee pursue a moratorium for a specific period of time on certain activities by financial institutions, including both deposit-taking institutions and non-depository institutions, we recognize that several companies within the insurance industry are taking legal advantage of some of the inconsistencies in the Bank Holding Company Act and the Federal Deposit Insurance Act.

The rush to obtain charters for non-bank banks started shortly after the Garn-St Germain Depository Institutions Act was signed into law last October. As previously discussed, that Act authorized banks and thrift institutions to offer MMDAs for the first time. Commencing December 14, 1982, banks and thrift institutions offering MMDAs could compete with traditional money market funds and were given the added advantage that their MMDAs of $100,000 or less were fully insured by the FDIC or the FSLIC. The sponsoring banks or thrifts were not required to lower their yield to take account of the insurance. The result of this considerable competitive advantage was soon felt by the mutual fund industry as investors began redeeming billions of dollars of money market fund shares to invest in MMDAs -- the same product but with free federal insurance.

In order to stem the outflow of these dollars, money market funds sought to find a way to offer their product with the same "free" insurance. One approach was to buy banks or thrift institutions and to convert them to something other than a "bank" for purposes of the Bank Holding Company Act, but to maintain their status as a "bank" for purposes of receiving federal deposit insurance. Thus, traditional sponsors of money market funds, including insurance companies, attempted to compete with bank sponsored MMDAs receiving federal deposit insurance.

Although I cannot speak for the entire insurance industry, I can say with certainty that a principal reason for an insurance company to obtain a charter for a non-bank bank is to compete with bank sponsored MMDAs. As evidenced by their willingness to dispose of their demand deposits or commercial lending facilities, companies seeking charters for non-bank banks are not motivated by circumventing federal prohibitions against combining the offering of normal banking services with engaging in non-banking activities. These companies are interested in being able to offer money market funds without being put at a competitive disadvantage by the lack of federal deposit insurance.

Unlike some bank holding companies that have attempted to circumvent the letter and spirit of the Bank Holding Company Act by holding out promises of new jobs for economically distressed states, insurance companies have sought to achieve parity of competition within the parameters of permissible authority.

Conclusion

The special role that banks play in our economy as financial intermediaries and as backup sources of liquidity and credit for all other institutions demands that any proposals to permit combinations of banking and other forms of commerce be carefully scrutinized. If banks, thrifts and their consumers are to continue to receive the same protection they have been afforded by the federal government over the last 50 years, this analysis and any resultant changes must be made by Congress. Otherwise, states such as South Dakota will continue to enact laws that will materially change the essence of the banking system of the entire country.

Since the issues now being addressed by Congress relating to the structure of banking regulations come at a time when states are being encouraged to act for totally extraneous reasons, we support Chairman Volcker's suggestion that a moratorium be imposed barring combinations of thrift institutions or non-bank banks with non-banking institutions.

Whether or not Congress decides to enact such a moratorium, we urge Congress to amend the Bank Holding Company Act to make clear that states will not be able to accomplish a circumvention of that Act in the manner attempted by the law enacted in South Dakota. If such action is not taken, it means that the actions of a single state can nullify Title VI of the Garn-St Germain Act.

Mr. Chairman, I once again thank the Committee for the opportunity to present the views of the American Insurance Association. I will be happy to answer any questions the Committee may have.

The CHAIRMAN. Thank you.
Mr. Nangle.

STATEMENT OF JOHN NANGLE, ASSISTANT VICE PRESIDENT OF THE NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

Mr. NANGLE. Thank you, Mr. Chairman.
[The complete statement follows:]

STATEMENT OF JOHN NANGLE
ASSISTANT VICE PRESIDENT & ASSISTANT GENERAL COUNSEL
NATIONAL ASSOCIATION OF INDEPENDENT INSURERS
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS
OVERSIGHT HEARINGS ON BANK DEREGULATION

JUNE 7, 1983

The National Association of Independent Insurers (NAII) is a voluntary national property and casualty insurance trade association of more than 530 member companies. Our members range from the small one-state writers to the very largest national writers. They are stock, mutual and reciprocal companies and they have a mix of merchandising the insurance product from agency to direct writer and direct mail. Our members underwrite approximately 38 per cent of the automobiles and 28 per cent of the homes in our nation which are insured. Workers' compensation and commercial lines are written, but to a less significant degree.

NAII's position in the first act of this opera is clear. We welcome competition and change. However, when the curtain falls, the underwriting of insurance must be accomplished through a separate corporate entity and regulated totally at the state level by the various insurance departments in place, without a scintilla of federal pre-emption of their affairs. Because all commercial enterprises involved are still in the process of sorting out events in the marketplace, which are running far ahead of the multiple regulatory system, and in a legislative vacuum, we support the moratorium which we understand will be introduced in a few days.

At this stage of fast-paced changing events in the financial services area, the vast majority of our members are in the process of absorbing as much of the information that is available. To the extent it is feasible, we are endeavoring to project just where these events will lead, how they will fit in that picture, and what their options might be. These companies were created in a highly competitive environment and by and large have thrived under it. They will be prepared for whatever form or shape the delivery of financial services may take. We are aware, too, that some positioning has taken place in anticipation of the future. For example, the retailer parent of one of our members has purchased a small bank; the parent of another member has owned a large savings and loan for many years; and two of our members have made arrangements to sell insurance within the branches of thrift institutions. We hasten to add, however, that each of these ventures are separate and distinct corporate entities subject to all applicable laws related to each enterprise.

It is not trite to say that whatever the structure will look like after the smoke clears, it will be the consumer who dictates it. Through banks, bank holding companies, brokerage, real estate, and insurers all have their turf to protect in any change, our interests must focus on the consumers and how these changes will affect them. We should consider their privacy, protections against over extensions of credit, protection against fraud upon consumers, and so forth.

Insurers and banks have been in conflict with each other for over 50 years, and, despite financial integration, will remain so. The boycott of specific insurers and the use of credit leverage to tie in the sale of insurance are ready examples of this conflict. How much more serious this abuse will become in the event banks and thrifts are allowed to underwrite insurance through their own subsidiaries, or worst of all, through the same company, remains to be seen.

More pervasive and less easy to identify is the passive tie-in. Lenders do not have to be so crude as to require the purchase of their insurance as a condition for granting a loan. Many of us have experienced the subtle inference while filling out a loan application as we consider the question about insurance. Conceding the lender has done his level best to assure the applicant that he or she does not have to buy the bank's insurance to get the loan, nevertheless the feeling, particularly among less sophisticated borrowers, persists that it will in a way help him obtain that loan. Frankly, until we find a better way in which this elusive tie-in puzzle can be solved, we supported the amendatory language in the Garn-St. Germain Act of last session, firming up the prohibition in 12 USC 1843 (c) (8) of the Bank Holding Act, as the best way to proceed.

Consumers should also be concerned, in a one-stop financial world, about the privacy of their various transactions and the potentially detrimental effect on their entire financial picture. Consider accounts with one entity which involve a home mortgage, auto loans, insurance purchase, depository account, savings account, and charge card privileges. With intro-access to financial history between each department, would an honest difference of opinion regarding a significant charge on the card jeopardize that consumer's total financial standing?

Other questions are unanswered. Where tie-ins exist, how will the consumer really be able to make informed and independent choices in this new world of integrated financial services?

What protections will be in the system to ensure fair and equal treatment for all customers for the range of services offered?

These questions and others demonstrate the need for close, continuous, accessible regulation. We have no doubt about the ability of the state insurance departments to monitor the insurance activities in the best interest of the consumer. Our experience through the years has proved to us that the insurance departments have ably administered their trust, through market conduct examinations and vigorous enforcement of unfair trade and claims practices acts.

The Baldwin-United debacle is a current illustration of the risks and difficulties of regulation. Though some criticism has been leveled against the regulators in the case, every indication is that it was in large part the insurance regulators in New York and Arkansas who brought about the inquiries into the safety of the so-called single payment deferred annuities.

Unbelievable, here is the reaction of a spokesman for one of the lender banks on the possibility of the sale of a Baldwin-United subsidiary -- MGIC -- as reported in Forbes on May 9, 1983: "Banks are hoping if MGIC is sold for less than $1 billion, they can get their money before the state insurance commissioners realize what has happened to the SPDA holders, whom the commissioners are supposed to protect. ...Sources say the major reason the banks agreed to a recent 90-day loan extension was that a bankruptcy judge might take more pity on annuitants than the banks."

We suspect that this cavalier attitude might not change significantly in the banks' future dealings with their consumers in the new world of integrated services. If Baldwin-United is an example of the laissez faire capitalism that some bankers espouse, perhaps this is the kind of change none of us needs.

I might add, by way of contrast, that the property and casualty insurers have provided for the protection of consumers through insurer insolvency by promoting legislative enactment of guaranty fund legislation in all 50 states.

A guaranty fund provides, in proportion to their market share of business in a state, that the insurers doing business in that state pick up the losses suffered by consumers due to an insolvency. These funds do not involve the full faith and credit of any state, as the FSLIC and FDIC insurance programs do involve the federal government.

As every insurance commissioner knows, the prime job of the regulator is to regulate for solvency. In the Baldwin-United case, that job was made exceedingly difficult by the complex array of companies, subsidiaries, shifting of assets and so on. For this reason, we were alarmed when South Dakota passed a law this year allowing banks to underwrite insurance within its own corporate structure. Proper regulation for solvency requires a separate corporation at the very least, for without a separate entity, examiners find themselves snowshoeing through drifts of commingled assets and inter-transfer of funds between a holding company's sister company a la Baldwin-United. We believe that the South Dakota legislature disregarded the welfare of its citizens and totally abandoned sound economic and business judgment. And it's interesting to note that when the insurance commissioner of the state raised the question of whether he would be able to regulate properly under the new law, he was fired.

Your Committee is well aware that for all who appear as witnesses in these hearings, where we stand really depends on where we sit. Confucius wished for all of us to live through interesting times and none of us can deny that these are interesting and exciting times for the purveyors of financial services. We are convinced that change is sweeping the land. We do not doubt that insurers will find their niche in the financial services future. We do not intend to build a Chinese wall around the insurance industry, so that we will suffer the fate of the railroads. Yet there seems to be a mad dash by the bankers to get into the insurance business. The cyclical nature of the property and casualty business, particularly the blood bath of circa 1974 and the past year, would dictate that it would be sound judgment for banks to cool their desire to enter our arena. Specifically the property and casualty insurers in the ten-year period from 1971 through 1980 suffered an underwriting loss on all lines of -.1 per cent for every dollar taken in. We suppose though that, given the opportunity, the banks will jump in with both feet to gather the goodies they suspect are there.

This entry will take place in spite of the conclusion contained in a study by Arthur Young & Company, commissioned by the American Bankers Association in February of this year. In the Project Summary their findings concerning bank entry into insurance underwriting states in part:

> "Bank image, lack of requisite skills, lack of product fit and heavy training needed for entry all contribute to relatively poor positioning. Lack of competitive advantages is accompanied by high underwriting risk and few competitive pressures motivating defensive strategy."

We know that competition works, but as Professor Edward Kane of Ohio State University has said, "sometimes with a long and variable lag." The end result after this lag, coupled with not-so-responsible competition, is a complete disruption of the marketplace and a confusion among the purloined policyholders. Banks, which have sought the great blue yonder in overseas lending at much higher rates than they had to pay for the money they loaned, and with very little regard for adverse cycles and repayment, would not have the International Monetary Fund as their backup to bail them out of their insurance losses.

On the other hand, the competitive atmosphere which we have historically espoused and will continue to promote, does not mean "anything goes" or "do what you will" where no weight is to be given to arguments relating to economics. Fair competition requires equity and parity between the parties. With radical and swift change without legislative consideration and restraint, we are convinced that the end product would be a sad state of affairs for all but a very few surviving giants. As an example of the type of service those giants may offer, we need only look at one large bank which recently tried to require a $5,000 deposit before a depositor could deal with a live teller. Is this what the average middle-class consumer really wants?

There are about 3,000 property and casualty insurers serving the public for automobile and fire policies. Obviously, only a handful of these companies have the capability of buying banks, brokerage houses, and the like. They are not afraid of the future, but frankly, the options available to them are limited. They will find a way to survive, perhaps by working arrangements among themselves and other types of financial services. But, as small ships must sail close to shore, most insurers must have a clear view of what this new world will look like before they close on their options, for their ability to suffer through gross mistakes is restricted and they have very little margin for such mistakes.

In conclusion, we support the proposed moratorium, but not as a delaying ploy - not at all. This should not be a time for foot dragging. But the moratorium would give all parties -- the legislative, regulatory, and private business interests -- a chance to sort out the myriad knotty issues and problems. A moratorium is vital so that Congress, the financial entities involved, and their regulators will have the opportunity to make a thorough analysis of the effects these future combinations will have on consumers and our financial system. The regulatory bodies themselves must have clear boundaries and authority over their respective changes.

For the interest of all concerned and particularly for the interest of the consumer, we believe that those aspects involving insurance in any integrated structure must be regulated by the several state insurance departments and those aspects of insurance must be carried on in a separate corporate entity. We fully support Commissioner Bruce Foudree of Iowa, who testified before you on May 20th for the NAIC, that the basic principles which must be adhered to are:

(1) the segregation of the assets of an insurance operation through a separate subsidiary in order to assure policyholder protection from the potential adverse economic experience of the parent or its non-insurance affiliates;

(2) regulatory oversight of asset and dividend transfers from the insurance operation to the parent or its affiliates; and

(3) application of normal insurance regulation and oversight to the insurance subsidiary's activities. Thus, financial transactions between affiliates are limited and subject to strict supervision.

We appreciate the opportunity this Committee has given us to express our views on this extremely important subject. These hearings are providing the essential basis for formulating the public policy framework which should evolve from the proposed moratorium. The NAII staff and its member companies would be privileged to aid your Committee and staff in any way our services could be of value to you.

The CHAIRMAN. Thank you, Mr. Nangle.

IMPACT OF MORATORIUM

Once again, as the first panel, you are proposing a moratorium or at least a willingness to support it, and I note your statement that it is not your intent to delay, and I certainly don't feel that anybody who is for the moratorium that that is their intent, but that has been my practical experience, that that's the way it works.

How do we overcome that? Suppose we put on a 6-month moratorium. How do you propose that we get Congress to act in that period of time when we are in our usual cycle of not having yet produced a budget resolution, not even the first budget resolution. We have a second concurrent resolution. We have 13 appropriations bills. We have a $1,400 million national debt. And a moratorium just says we don't have to think about that and we can go on with these other things.

How do we make it temporary? How do we get Congress to move?

Mr. NANGLE. Would it be possible with all that is going on to bring together all interested parties with the Senate Banking staff and hammer out a reasonable bill?

The CHAIRMAN. It took me 2 years of knocking heads to produce Garn-St Germain and these are even more controversial and difficult issues in many cases than that. That was a 2-year process. So are we talking about a 2-year moratorium, just trying to freeze everything in place for 2 years for another cycle? You see the dilemma I'm faced with. I would like Congress to act. After these hearings I would be willing to make recommendations and say, OK, Congress, look at them, vote them up or down, change them, do what you want with them, but let's act. I don't know how to do that. As I say, it took 2 years to go through the other process and these are more difficult. So I hate to go to a moratorium. I would like to keep some pressure on for Congress to do something more quickly. When everybody advocates that we do things deliberatively, we do. No one needs to testify that Congress acts deliberatively. We are so deliberate that you could serve here 18 years and have never accomplished anything. It doesn't happen.

Mr. NANGLE. Senator, I think the thrust of our statement is that the alternative is even more disorder and worse. If things continue the way they are, there's going to be chaos out there. That's really the thrust of what we're saying.

I appreciate the problems that Congress has and I know the problems you went through last year or the last 2 years with the Garn-St Germain Act. Does it have to be 2 years? I don't know.

The CHAIRMAN. Well, that was a relatively brief period of time.

Mr. SUTTLE. I would defer to my distinguished colleague on how to get the Congress to act.

The CHAIRMAN. I was going to turn to Dick next and see if he had any solutions to the problem.

Mr. SCHWEIKER. Mr. Chairman, let me just say that our industry basically supports your main proposition here and would prefer to see action first as opposed to a moratorium. If that's at all possible, we'll certainly be supportive and helpful in working on putting such a proposal together. So I concur with your first point.

On the second part of the question, if legislation can't be passed quickly, then I think the moratorium is probably the best that we can come up with. I see a real competitive panic setting in out there. There is a tremendous rush by financial institutions to be the firstest with the mostest. This is evidenced by the end run that was made by South Dakota. And while we maybe had the luxury earlier on of hoping that it would get straightened out and rectified, it's probably going to get worse and accelerate because of this competitive panic that I see among institutions. And that's among all institutions, not just banking institutions, but insurance institutions and other financial institutions as well.

And the other thing that I think is significant is that this is going to change the whole landscape of the Federal regulatory scheme governing banks for years to come. South Dakota effectively wrote the Federal law for 49 other States and the Federal Government. It's a very unique thing that they did and that really turns this thing upside down and suggests that one State now can dictate the elements stability and safety for our national banking system. That's why I think, Mr. Chairman, there is a crisis.

I really don't disagree with your point that if we pass a moratorium it may prolong the pain. We would prefer to pass a bill right from the start.

The CHAIRMAN. Well, as you know, Dick, when we talk about—I'm really in error when I talk about 2 years to produce Garn-St Germain simply because there was not a single issue that had not been talked about before I became a Senator and before you became a Senator. So that process was a long number of years. Many parts of that had passed the Senate before and not passed the House. There was nothing new or original in that and it took a crisis to precipitate that kind of action finally. So it isn't just a 2-year process.

Mr. SCHWEIKER. Well, you're absolutely right about that, Mr. Chairman. Let me say that when I was a member of the administration, there was no question that the driving force was the crisis in the thrift industry. That was the precipitating factor.

I guess what has us concerned here is that we see a somewhat different situation in that the rules of the game have changed so dramatically and so fast that if we aren't able to put forth a major bill, and if we don't have a moratorium, by the time that we do do something, given your 2-year cycle theory which is probably correct, there won't be anything left to do. We'll be totally preempted in this area as I see it. And then so many financial institutions, including some of our own members, will have changed the status quo, that it will be four or five times more difficult to get legislation 6 months or 1 or 2 years from now. Everybody will have changed the rules and have their own vision of how the future looks. That's why I hate to see the Federal Government lose its appropriate role, even though I thoroughly agree with the point the Chairman is making.

Mr. SUTTLE. Mr. Chairman, I would only add that, while sharing your frustration and all Mr. Schweiker has said, our support for the moratorium was, among other things, precipitated by—I believe it was your opening statement on the first day of the hearings when Mr. Regan testified that you anticipated that this process or these oversight hearings would probably take at least 2 years.

The action in South Dakota, the pending action in Delaware, heaven only knows where else it might strike. We're concerned about what might take place in the marketplace between now and the time that the Congress can through its normal deliberative process reach some solution.

I don't think the crisis will go away by the passage of a moratorium. It might not speed the process at all, but I doubt seriously that it would end it.

The CHAIRMAN. But I'm sure you all recognize that there will always be some problem.

Mr. SUTTLE. Yes, sir.

The CHAIRMAN. No matter what we do, when we pass a moratorium and assume at the end of that moratorium we end up with some additional legislation, someone out there is going to be innovative enough to figure some way around it. We're training tens of thousands of them in the law schools to figure out how to get around these laws. And so do we go through a constant process—ah, another moratorium, they figured out another loophole; or do we address the problem? I suppose it's good I've already lost my hair; I'd tear it out in frustration at the inability to get Congress to face up and make decisions rather than trying to stall and delay.

INSURERS FACING SEX DISCRIMINATION ISSUE

If I might change the subject for a moment, Senator Schweiker, and go to another area that is not directly involved in today's hearing, but the issue that you and other insurers are facing on the matter of sex discrimination and any comments you would like to make on that particular issue.

Mr. SCHWEIKER. Mr. Chairman, our concern in this particular area is that it is a very complex subject with a lot of spinoffs. Roughly 90 percent of the women today are covered by some kind of defined benefit program. If they're covered by that, they are getting equal pay and equal treatment. So you're dealing with the 10 percent who may not be.

The question then becomes, Are you going to change the ground rules and the whole classification system for all lines of insurance for that 10 percent? This would mean in life insurance, that 50 percent of women would end up paying 10 to 30 percent more for their life insurance.

In automobile insurance, 100 percent of women 25 and under would have to pay higher rates for their insurance.

Thus, the question becomes, Who's really helped and who's really hurt? Some people would logically argue, do I need that kind of reform and change?

I think one other spinoff is that if you take the bill, as written, you have the matter of the surviving spouse. If we bring down the rate, say, on an annuity for a man and bring the woman's rate up to an average, as soon as the man dies, the surviving spouse rate is reduced. And, since women do live 8 years longer now than men—and the latest study says it's going up to 12 years by the end of the century—a woman will get hurt as a surviving spouse, where they're getting the benefit because men do die younger.

There are just a lot of complications. What starts out as a good principle in practice hurts a lot of women in a lot of different ways. I think our job is simply to lay it all out, to explain that it cuts both ways and that people who think it's a one-way street are totally mistaken. A lot of people are going to realize that their life insurance premium went up, that their auto insurance premium went way up, or that their surviving spouse policy went way down.

So those are the things that we hope Congress will consider before enacting legislation.

The CHAIRMAN. I would hope Congress would consider it carefully rather than just rushing into it as a discrimination issue between men and women. I personally would be very, very happy to trade whatever discrimination rates exists for the 8 to 12 longer life expectancy, particularly as a father of an 11-month-old, I hope I survive like Strom Thurmond so that I can get him educated and so on. So I fail to understand the issue when statistics are so overwhelming. How do you equalize that sort of a situation when the life expectancy is so dramatically longer, and I'm not being facetious when I say that I would be more than happy—I feel discriminated against as a male that I have a shorter period of time to live. Also, women don't seem to have the trouble we do with our hairlines and things of that nature. I would be glad to trade some of that, too.

Mr. SUTTLE. If you find a trading market, I would happily join you, Senator, with the hairline. I would only say "amen" to what Mr. Schweiker has said and point out that sometimes issues like sex discrimination in insurance become so entangled in rhetoric about principle and public policy that they totally ignore the marketplace and I think the Senator having been in the insurance business, can appreciate what would happen in the insurance markets if you ask insurers to ignore realities in the marketplace, to be required in the case of automobile insurance to significantly overprice one group of risks and significantly underprice another group of risks.

It's going to invite selection of the kind that's going to force Government to come along with still more regulation and therefore force insurers to do things that are not a part of the basic business of insurance. We are deeply concerned not only with the argument that you make and that Mr. Schweiker makes, but about the fact that you cannot cure public policy concerns by asking a competitive marketplace to ignore reality. It just won't work that way, nor would it work in the life insurance business or property and casualty insurance business, in our humble opinion.

The CHAIRMAN. Let me just say when you refer to the marketplace, there certainly is a lot of discrimination in the marketplace in other areas between men and women and that ought to be corrected. The reason I consider this marketplace different, it isn't a matter of the marketplace; it is a matter of the physical fact of life, statistically proved over and over and over again that there is a difference in life expectancy and no law in the world can change that. If it could, I would demand equal treatment for us. I'm not being facetious at all. This one is just a physical fact of life that we cannot change. It isn't the marketplace or anything else. It's simply a matter that women do live longer and I'm jealous.

Mr. SCHWEIKER. Mr. Chairman, because of my former role, I can't resist commenting on one other aspect of the difference between men and women. There is a new study that came out out of NIH that basically concludes that the lack of a female hormone in a male is one of the key indicators of whether that man is going to have a heart attack. We can now predict heart attacks in men under this study based on the degree of female hormones that he has.

The other correlation which I think gets to this whole issue is that women, before menopause, have very few heart attacks compared to men because they have a very high degree of this female hormone. After menopause, they have a very low degree, and then their heart attack rate goes up to about a man's rate. So we are finding there is a direct, scientific linkage that's quite validly explained.

The CHAIRMAN. So what are you telling us? That those with hairlines like mine are in great difficulty then? Should I go have an EKG this afternoon? [Laughter.]

You raise the example of the REIT experience in the 1970's when the banks channeled financial assistance to REIT's to keep them afloat. For that reason, the Garn-St Germain amended section 23(a) to include bank-sponsored REIT's within its restrictions.

If section 23(a) was deemed sufficient to preclude a reoccurrence of the REIT experience, do you think that we might consider that those changes were sufficient to preclude similar experiences between banks and their insurance affiliates? That's to any of you that wish to respond.

Mr. SUTTLE. Mr. Chairman, while he confers, I would just say that the experience with REIT's I think is an excellent example of the difficulty of combining the business of banking with some risky, unpredictable other form of commerce. And whether or not the mere prohibition in Garn-St Germain is sufficient to protect against further problems like those that occurred in the early 1970's or not, I'm not sufficiently expert in banking to say.

The Chairman. Well, as you remember, the point was made very strongly that if you put other types of activities into a separate subsidiary, that that insulates the parent organization. It did not. That's why I resisted, when we talked about money market mutual funds and municipal revenue bonds, the idea that they be placed in separate subsidiaries which is the Treasury position. That simply did not accomplish that insulation and protect the parent company, but as I say, we did make some changes in 23(a), hopefully at least to correct that problem from recurring.

My question is simply whether it was sufficient for REIT's, why not other types of activities?

Mr. SUTTLE. We have argued that the REIT's experience is one example of the fact that merely separating functions by separate subsidiaries or affiliates is not necessarily in and of itself sufficient protection for the assets of the banks and the depositors' funds. We think that's a good example of the fact that merely separating, as the Treasury suggests, without other safeguards, is not sufficient to protect the assets of the deposit-taking institution.

Mr. SCHWEIKER. I might just add, Mr. Chairman, that the Minneapolis Fed study really makes the same point, that putting these activities into a separate subsidiary really isn't a sufficient safeguard, and we have to look to other means.

The CHAIRMAN. Thank you. Gentlemen, I don't have any additional questions for the hearing today. Do you have any remarks you would like to make in closing?

Mr. NANGLE. Mr. Chairman, so that the companies and my executives back in Chicago will know that I've done my duty down here, may I submit some comments for the record on S. 372?

The CHAIRMAN. Certainly you may. We would be happy to receive them.

[Additional comments by Mr. Nangle can be found on pps. 343–348.]

Thank you very much, gentlemen.

The committee is adjourned.

[Whereupon, at 11:15 a.m., the hearing was recessed, to be reconvened at 9:30 a.m., Wednesday, June 8, 1983.]

[Additional material supplied for the record follows:]

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May 25, 1983

The Honorable Jake Garn, Chairman
Senate Committee on Banking, Housing
and Urban Affairs
Dirksen Senate Office Building, Room 534
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

The Alliance of American Insurers is a national association of 160 property and casualty insurance companies doing business in all states and the District of Columbia.

We very much appreciate the opportunity to provide to the Senate Banking, Housing and Urban Affairs Committee our views on integration of financial services.

It is quite obvious that the financial services industry is undergoing a major restructuring. We believe that the separate entities linking this industry will probably undergo, within the next five years, more fundamental changes than the business has seen in the prior century. While financial conglomerates will develop through the inter-mediation of financial institutions, regional and local companies will likewise be affected by the changes. In fact, we believe that all companies, whether or not they become involved in the new financial services, will be affected by the necessary regulatory changes accompanying the development of the new financial services industry.

We congratulate you, Mr. Chairman, for the time and resources which you and the Committee are investing in this issue. Too often major changes in institutional behaviors are allowed to proceed in a vacuum and end up by dictating the regulatory response and environment. We believe that under your leadership regulation will preceed change and therefore dictate its degree and speed.

For the past several months, we in the Alliance have also spent a great deal of time assessing the changes which have occurred in the financial services industry, the impact which these changes have had on the various segments of the industry, including insurance companies, banks, security firms and other financial entities. We have also attempted to project what the future may hold as financial institutions modify services and diversify into related businesses.

Working to Make Insurance Work Better

These considerations have been brought together in a discussion paper which we are now widely distributing with the hope that it will foster a better understanding of the many public policy issues involved and will assist the inquiry into the effectiveness of present and proposed regulation to assure fair competition and protection of the consumer. A copy of the paper is attached to this letter.

As a matter of broad public policy, the Alliance would not oppose permitting financial institutions to underwrite property and casualty insurance. Our companies believe in competition. We do not "select" our competitors. Competition generates innovation; it stimulates quality service; it controls price. However, in order to achieve these results, competition must be fair; competitors must be made to conform on a uniform basis to applicable laws and regulations and consumers must be protected.

There are, we believe, serious problems to overcome if fair competition and consumer protection are to result from integration. We believe that the obstacles which we and others have identified can be overcome. The debate which you have engendered on the issue will go a long way in their resolutions.

We do not mean to minimize the difficulties which lie ahead of us.

To a large degree, these difficulties reside in the fact that banks are unique. They are the primary source of liquidity for all other classes and sizes of institutions, both financial and nonfinancial. Banks provide loan commitments and letters of credit in addition to continuing lines of credit. Virtually all other financial markets and other classes of institutions are directly or indirectly dependent on the banking system as their standby sources of credit and liquidity. Banks can do this because they have access to deposits and to federal money. The ultimate question is -- If banks are to be permitted to underwrite insurance -- can there be equality of regulation in light of the unique, inherent advantages which they enjoy?

Laying aside uniqueness and potential inherent competitive advantages, one must address the other regulatory implications and problems which will arise if the financial services marketplace continues to evolve to a point where banks will be allowed to underwrite insurance.

First, of course, is the need to insure a level regulatory playing field, or, in other words, regulatory equality.

Achieving a level regulatory playing field on which the different types of financial institutions can compete equally has been widely supported by both public officials and by participants in the industries involved. It appears, however, that public utterences and private feelings are often at odds with each other. Each industry seems anxious to obtain its own advantage when its firms enter new financial service activities while at the same time maintaining its present advantages when firms from other industries seek to enter its preserve. Clearly, all businesses must be subject to the same regulatory ground rules if they are to compete in the same areas.

Second, there must be consideration of the potentials for unfair trade practices.

Commercial banks, because of the special leverage associated with their lending power, are in a position to suggest to their credit customers that it is in the customers best interest to use other services offered by the bank. Subtle cohersion, instead of creating competition, actually stifles it. This type of pressure or tie-in sale hampers competition by eliminating product quality and price as considerations in the consumers purchasing decision. Effective deterrents to such pressure must be found. Broadened entry of banks into insurance and other nonbank areas could easily exacerbate this leverage problem.

Third, there could be conflicts created by the existence of multiple insolvency funds and programs.

The banks have a significant advantage in having the government insure deposits through the FDIC. How will the FDIC, state insurance property and casualty insurance insolvency funds, state life and health insurance insolvency funds and the Securities Investors Protection Corporation Act interrelate if banks enter the insurance business? Will there be a segregation of assets, liabilities, reserves, so that should an insolvency occur one could be assured that the assets which back up certain portions of the business are in fact attributed to that portion? Will reinsurance purchased to protect against certain risks be considered assets of the bank and thereby subject to claims by bank creditors?

Fourth is the question of taxes and accounting.

Insurance companies are taxed differently than banks. In fact, there is a very wide difference in the way property and casualty insurers, on the one hand and life insurers on the other are taxed. Federal taxation for insurance is different, partially because insurers taxes are derived from their annual statements. These statements must comply with the National Association of Insurance Commissioners (NAIC) Convention which dictates the use of statutory accounting. The banks, on the other hand, use GAAP accounting. Using the NAIC Annual Statement Method of Accounting is essential for insurance purposes in order to protect consumers against insurance company insolvencies.

Will the conversions of banks and insurers produce a move toward GAAP accounting for insurers? Will banks participation in the insurance business be organized such that the insurance portion of the bank will pay federal income taxes, premium taxes and other state fees and assessments as do insurers? In almost all states, banks, like most other businesses, pay corporate income taxes while insurers pay premium taxes, which are generally larger. Again, the banking and insurance entities must be separate so that the banking business can use GAAP and the insurance business can use statutory accounting. This may require complete walling off of the assets of the bank from those of its insurance business.

Fifth is the issue of convergence of regulation.

One significant question which must be answered is who will regulate each portion of the entities? Banks as you well know, are presently regulated by a combination of state and federal regulators. The question is, who will regulate the insurance function of a bank?

Will it be one of the federal bank regulators, the state bank regulator, or the state insurance regulator? Will it be a combination of all of the above? If the insurance function of a bank is subject to federal regulation, will other insurers be brought within the purview of such federal regulation? If the insurance function of a bank is regulated by a bank commissioner be that federal or state, will such regulation be the same as regulation at the state level by an insurance commissioner? Parity of regulation between conventional insurers and those run by banks is paramount.

Sixth is the issue of examinations.

Which regulator will be responsible for the conduct of financial and market conduct examinations? Will the bank regulator be willing to rely on the financial or market conduct examination of an insurance commissioner where an insurance entity attached to the bank is involved. On the other hand, will banks allow insurance commissioners to examine the insurance function of a banking entity?

Mr. Chairman, the perplexities of these issues should not deter us from seeking solutions. We believe that the suggestions made by Treasury Secretary Donald Regan in testimony before your Committee on April 6th establish a framework within which these problems should be discussed. Secretary Regan's criteria were:

- The insurance function of a bank should be regulated by state agencies at the state level. In other words, state regulation of the insurance would control, whether the regulatee is a bank or an insurance company.
- There should be an equal regulatory playing field. Simply stated, the insurance function of a bank should be subjected to the same regulatory requirements as are other insurers.
- The insurance function of a bank should be conducted through a subsidiary. Secretary Regan was suggesting that the easiest way to trigger the existing body of insurance law so that there would be equal application of that body of law to both the insurance function of the bank and to insurance companies is by requiring the establishment of a separate insurance subsidiary.

We might comment that while as suggested by Mr. Regan, the easiest way to trigger the existing body of insurance law is to require a bank to establish an insurance subsidiary, the same goal can be obtained by applying that body of law to the insurance function of the bank if such function is conducted as a separate division or department of a bank. In other words, while much more difficult, one might be able to obtain the same equality of regulation without a subsidiary. The objective here is to achieve equality of regulation and not necessarily to establish a separate insurance subsidiary.

- Mr. Regan suggested a need to wall off the bank assets in order to protect bank consumers in any integrated activity. We would suggest that there is a similar need to "wall off" insurance assets in order to protect insurance policyholders and claimants in such programs.
- The Secretary proposed that laws prohibiting tie-in sales between banks and other functions of the bank must be strengthened to insure competition. Of all the obstacles which we have identified, the most difficult to overcome will be to insure fair trade practices among competitors. Yet, it is essential that this be accomplished to insure that the benefits of integrated financial services shall inure to consumers and not to the industries involved.

Finally, Secretary Regan suggested that if there is to be integration of financial services, including the underwriting of insurance, the decision should be made by Congress and not by each individual state. The Secretary was referring to the recently enacted South Dakota law which allows such integration without any reasonable control or protection of consumers, as well as pending legislation in a number of states which also would allow such activities.

We too are concerned with the action taken by the South Dakota legislature. We are not however, as yet prepared to accept a federal preemption of the authority of banks and other financial institutions to enter the insurance business. We would support Federal Reserve Board Chairman Paul Volcker's suggestion that there be a temporary moratorium barring combinations of thrift institutions or "non-bank" banks with non-banking institutions so that Congress can properly make policy regarding such combinations. As we stated earlier in this letter, there is a need to establish the regulatory criteria before integration takes place. The South Dakota legislature has allowed integration to proceed with the expectation that regulation will follow as problems develop. This makes little sense to us. It is bound to disrupt markets and to affect consumers adversely. The suggestion that there be a moratorium is not intended to "kill" integration, but rather to allow integration to develop in a way to insure its success and to protect both competition and consumers.

In conclusion, Mr. Chairman, we believe that the debate which you have stimulated over the issue of financial services will ultimately provide us with an excellent framework within which public policy may evolve.
We would greatly appreciate if this letter and attachment could be made part of the hearing record.

Sincerely,

Andre Maisonpierre
Senior Vice President

AM:lbd
Attachment

The New FINANCIAL SERVICES

An overview of the changes occurring in the financial services industry. The paper discusses the impact of these changes on the various segments of the industry, including insurance companies, banks, securities firms and other financial entities. It also provides a look at what the future may hold as financial institutions modify services and diversify into related businesses.

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Introduction

The purpose of *The New Financial Services* is to enhance understanding and discussion of the financial services industry, especially the short and long-range implications of its "new" products, marketing, regulation and organization, as they affect consumers, business, government and insurers. This paper provides an overview of the financial services industry by identifying social, economic and political factors which have and will continue to generate change. It is the Alliance's intent that this paper foster review of the many public policy issues in the current financial services debate and inquiry into the effectiveness of current and proposed regulation to assure fair competition and consumer protection. Major subject areas of *The New Financial Services* include:

The Growth and Scope of Financial Services Institutions

In the past two years the integration and expansion of financial services have become increasingly apparent.

A corporation which merchandises washing machines and blue jeans also sells homes, markets stocks, offers life, health and auto insurance, and sponsors a money market fund.

A major New York bank sought and received approval of federal bank regulators to underwrite commercial paper offerings for its corporate customers — traditionally a securities function thought to be prohibited by federal banking laws.

One of the nation's largest credit companies now owns a major securities firm, several smaller ones, and a real estate development and syndication firm.

The increasing affluence of today's consumers has spawned a broad range of financial services, specialized banking services, investment advice, insurance, and stock brokerage services. High interest rates have brought personal investments into the securities and money market and out of low-yielding passbook savings accounts. As the money flowed, banks agitated for deregulation to stay competitive. And at the same time, non-bank financial services providers, having found success with their available products, realized an opportunity and set about pursuing those markets.

Reaganomics and the federal government have aided the financial services growth, too, by raising "savings consciousness" through tax changes, All-Saver Certificates, and IRA (Individual Retirement Account) expansion.

Financial Services Regulation: Current and Proposed

For over 50 years there has been a distinct separation between banking and commerce. The basis for this long-standing separation has been the power of banks to accept deposits and make loans, which could provide them with an inherently unfair competitive advantage over non-bank entities, and a recognition that unregulated non-bank enterprises could adversely affect the financial safety and soundness of the banking system.

The Glass-Steagall Act of 1933 largely prohibited banks and savings and loans from engaging in the securities business, and insurance companies with securities subsidiaries from pursuing the banking business.

As recently as October 1982, Congress enacted legislation known as the Garn-St. Germain bill which expressly reaffirmed the separation between banking and insurance established in the 1956 Bank Holding Company Act. The Independent Insurance Agents of America waged a 13-year battle on Capitol Hill to pass the federal legislation, only to face the issue in a dozen or more state legislatures in 1983.

On March 4, 1983, South Dakota became the first state to allow state banks, whether purchased or created by bank holding companies, to engage in all facets of the insurance business.

Citicorp, the nation's largest bank holding company, within a month of South Dakota's passage of this law, announced plans to buy

Rapid City's American State Bank, a state-chartered bank—and a potential first step toward offering insurance. A second South Dakota law, also approved in March 1983, allows insurance companies to engage in the banking business within the state.

South Dakota's new laws resulted in extensive regulation reviews by attorneys, insurers, financial services providers and security firms, and rumors of court challenges have been heard across the country. The Independent Insurance Agents of America is planning to file a petition with the Federal Reserve Board challenging insurance activity by bank holding companies through state banking subsidiaries.

At a March 6, 1983 Senate Banking Committee hearing, U.S. Treasury Secretary Donald Regan, who favors deregulation of the banking industry, said state laws allowing banks to sell and underwrite insurance (such as South Dakota's) were "inappropriate." If banks are given insurance powers, Regan said, the insurance assets should be "walled off" from the banking entity, preferably through subsidiaries to protect solvency. Regan hopes Congress will supersede state deregulation by resolving the issue at the federal level.

In April 1983, the Comptroller of Currency placed a moratorium on the federal chartering of "non-bank" banks (those that do not offer commercial loans) purchased by non-banking firms to avoid Bank Holding Company Act restrictions for the remainder of the year, in hopes of congressional action in the interim. Federal Reserve Board Chairman Paul Volcker, has also proposed that Congress temporarily ban acquisition of "non-bank" banks and savings and loans by non-depository institutions while Congress considers the issue. Basically, this would continue to prohibit insurers from buying banks for a while. This fall, a Cabinet-level committee, chaired by Vice President George Bush, will present recommendations on bank regulatory agency consolidations.

Insurers' Role in Integrated Financial Services

There are at least two sides to any issue, and integrated financial services is no exception. Some large insurance companies are already in the thick of financial services integration. A unit of The Prudential Insurance Company, which already owns a stock brokerage firm, is pursuing an opportunity to buy a Georgia bank. But some insurers are working to slow down the growth in financial services. The "Why Not Delaware Committee?", which works to attract insurance business to the state, has opposed expansion of Delaware's corporate laws to allow banks to own insurance companies. Whatever their views on the growth of financial services, many insurers will agree that the insurance industry itself needs some restructuring to expand markets, underwriting, subsidiaries, and complementary services.

State insurance regulators, through a National Association of Insurance Commissioners (NAIC) task force, are studying financial services integration as it affects insurance regulation. At its March 1983 meeting, the NAIC adopted a resolution opposing "permitting the banking industry to engage in the business of insurance without adequate analysis of the potential impact on the consuming public and on appropriate regulatory mechanisms at both state and federal levels."

Surfacing as a major concern of insurers and regulators alike is the need for a "level playing field." A complex system of insurance checks and balances now protects consumers, businesses and insurers. Insurer participation (both financial and operational) in FAIR plans, guaranty associations, and assigned risk plans, are some of these unique requirements. Insurers also have different tax structures, solvency tests, and accounting methods than other businesses. Still another distinguishing factor is that the insurance industry is regulated strictly on a state-by-state basis. Public policymakers must assure that banks writing insurance business pay their fair share to fund insurance social mechanisms and follow the same regulations insurers do.

Expansion of financial services is being promoted in some states as a "jobs generating" issue. Governor William Janklow used the lure of additional jobs to sell the recent South Dakota financial services law. Other states are looking at the possibility of attracting new employers, too, via similar legislation. Many have even considered specifying a minimum number of employees by a certain date as a condition of doing financial business in the state. Small insurance companies and agents see the job issue differently. The bottom line for many small insurers and agents is whether or not they could compete with the large, integrated financial services firms, or even with the local banks. Thus, the jobs issue may be more of a workforce shift from insurers to banks than a real gain of additional jobs.

Views From Other Financial Services Providers

The securities industry is particularly leery of banks entering its field and has voiced many of the same concerns which insurers have. The securities industry also seeks a "level playing field," elimination of unfair competition through rationalization of the differing capital structures imposed by regulation, and prevention of biased "tying" arrangements by banks when providing business or consumer services. It also questions whether the historical separation between banking and commerce should be destroyed.

The President of the Securities Industry Association, Edward O'Brien, has called for a complete review of laws and regulations covering financial services, with special emphasis on bank competition. He believes banks currently have advantages other financial services providers do not. O'Brien supports strengthening the Glass-Steagall Act.

Bankers aver that the competitive edge is not theirs, rather they are fighting to come back from their losses to the money market funds in the late 1970s and early 1980s. In order to survive, banks seek deregulation and elimination of banking laws promulgated in the depths of the Great Depression.

Not even all bankers agree on how integration should be approached. The concerns of the Independent Bankers Association of America, which represents small to moderate size banks, differ from those of the American Bankers Association, comprised principally of "money center" banks like Citicorp. The IBAA prefers no immediate legislation expanding bank powers, but rather continued case-by-case review by the Federal Reserve Board.

Projections

It is a certainty that the financial services industry is changing. How those changes will come about and what the changes will be remain unanswered questions. Several groups, from federal and state regulatory agencies to trade associations like the Alliance, are watching intensely the day-to-day developments. A few trade associations, including the American Council of Life Insurers and the American Bankers Association, have issued reports of financial services integration; while other studies like the one being prepared by the National Association of Insurance Commissioners are in various stages of research and publication. It appears that integral to all concerned is the need to define which institutions will provide financial services and what types of products they will provide; whether federal or state regulations will govern financial services; how parity can be achieved in the "new" financial services industry; and how the public can be protected.

Section I

What Are the New Financial Services?

Within the past few years, dramatic and far-reaching changes have been taking place in what once was regarded as a staid and segmented sector of commerce known as the financial services industry. The changes have been so sweeping that now it is referred to as the "new" financial services industry.

To put these changes in perspective, it should be noted that in the past banks, savings and loan associations, securities firms and insurers provided separate and distinct services, competing only within their own respective segments of the industry. Now, however, the traditional barriers to cross competition between the various sectors of the industry are eroding. Insurance companies are expanding their financial services and other providers of these services are seeking greater freedom from regulatory restraints.

Commercial banks and their holding companies are seeking powers similar to those of investment bankers. Thrift institutions are seeking expanded authority. Some insurers want authority to engage in the banking business if banks are permitted to engage in the business of insurance.

The insurance industry is facing a challenging new environment with possibilities for major changes in competition and economic conditions. Consumers have become more sensitive to interest rates and have increasingly demanded the unbundling of services and the provision of new services. Some observers believe the lines separating banks, savings and loans, securities firms and insurers may disappear altogether in the future; others think that few changes will be made. Following is a summary of recent developments in the financial services area.

Recent Examples of Change

Sears — The Sears organization includes retail stores, credit card operations, catalogs, Allstate Insurance Company and a California savings and loan. In 1982, Sears acquired the nation's largest independent realty broker, Coldwell Banker, and a major stock brokerage firm, Dean Witter Reynolds. Sears also has launched a financial center pilot program in a number of its stores. At these financial centers, customers may purchase insurance and other financial services.

American Express — American Express has acquired the securities firm of Shearson, Loeb & Rhoades, the second largest stock brokerage, and also owns Firemen's Fund Insurance Company.

The Prudential — Prudential bought the Bache Group in 1981, giving Prudential access to several Bache money market and other mutual funds. Prudential-Bache now offers a "bank-like" asset management account and has begun to experiment with locating Prudential agents and Prudential-Bache account executives in the same offices. The company's long range objective is to provide a full range of financial products and services to both the household and commercial segments of the marketplace. The emphasis is still on servicing household accounts through agents.

Merrill Lynch — This firm is the largest securities broker in the country in terms of number of offices and registered representatives. It was the first to offer such innovative services as the Cash Management Account (CMA), which set the pace in offering convenience to the "upscale" consumer. It also encourages customers to place other business with Merrill Lynch, creating a one-stop concept of shopping for financial services.

Section II

Pressures for Change

Two basic motivations underlie a business decision to diversify services or product lines. They are:

- The desire to spread overhead costs or management talents over a larger range of operations.
- The need to stabilize the earnings base by going into different lines of business where the cyclical ups and downs may be offsetting, thus providing a more certain profit trend through diversification.

These traditional factors alone, however, are not sufficient to explain the sudden upsurge in activity. For an explanation of current activities there are at least six other reasons.

Interest Rates — When market interest rates on treasury securities and related investment products entered into the double digit range, knowledgeable consumers rapidly shifted into the higher yields at the expense of traditional forms of saving, particularly where fixed rate ceilings were applicable. The crucial fact is not that the money flowed, but that the mutual fund industry designed products to capture that flow with a new combination of flexible and higher rates, small minimum denominations to attract most consumers, instant liquidity and even the power to pay bills to third parties.

Inflation Rates — Double digit inflation caused a distrust for long-term, fixed rate debt obligations and impelled consumers to search for other ways to invest their funds and conserve their capital.

Deregulation — The Reagan Administration's strong philosophy of deregulation prompted new financial services and affiliations. The Depository Institutions Deregulation and Monetary Control Act of 1980 is the most significant recent legislation which has spurred the financial services revolution. This Act put thrift institutions and credit unions on a more or less equal footing with banks. It gives them broader powers regarding loans and investments and the types of deposits and checking accounts they may offer. This Act also contains a federal usury law which will preempt state laws when applicable. When this law applies, there are no interest rate limitations applicable to the extension of credit and the amount of interest payable will be governed exclusively by the agreement between the parties.

In other words. the different interest rate ceilings applicable to these different kinds of financial institutions have been eliminated for certain kinds of transactions. Also under the Reagan Administration, savings and loans have added direct deposits, home improvement loans, pre-authorized payments and trust accounts to their acquired powers. In short, regulation that insulates market segments from competition is becoming passe.

Income Tax Rates — Consumers are looking for relief from high taxes and Congress helped them by providing two new channels — the All-Savers Certificate (now defunct) and the expanded form of the Individual Retirement Account.

Technological Change — Data processing and data transmission have become so economical and sophisticated that a wide range of new services is now feasible. Complex customer accounts can be produced monthly for the smallest depositor at a very low cost. Such accounting now permits the interaction between checking accounts and savings accounts and can even handle "sweep accounts" which send excess money into money market funds to maximize investment yields. Many experts believe that this new technology will overwhelm the existing regulatory process. Technology will bypass current regulatory limits and make such limits pointless. Then, laws and regulations will have to be altered or removed to reflect existing technology, as may happen soon with respect to geographical boundries.

Social Concerns — Many of the existing regulatory barriers dotting our economic landscape were erected as a result of the stock market crash of 1929. The fear of overly-concentrated financial power was a major concern 50 years ago, but now many see large businesses as a source of both economic efficiency and useful innovation to the advantage of the consumer.

Section III

The Insurance Perspective

Insurance industry expansion into the financial services area has been hampered by laws and regulations. This section does not necessarily represent Alliance of American Insurers' policy, but does present the views of some insurance people. Among impediments listed by the latter are:

Limited Insurance Powers: Most insurance companies are limited with respect to the lines and kinds of insurance which may be combined in a single company. Such prohibitions or limitations on the ability of insurers to provide consumers with all lines of insurance directly have resulted in formation of insurance subsidiaries to write additional lines of business. All states permit property/casualty insurers to own life insurance subsidiaries while all states except Pennsylvania permit life insurers to own property/casualty insurers.

Limited Reinsurance Powers: Generally, insurers can reinsure any kind of insurance which they can write directly. However, most insurers are precluded from reinsuring types of risks which they do not write directly. Such restrictions have resulted in insurers forming subsidiaries to provide reinsurance for lines not written directly. The subsidiary form is inherently expensive because of the extensive separate regulations, bylaws, charters, policy forms, records, accounts, financial statements, tax returns, licensing and other overhead associated with a separate corporate entity.

Limited Direct Business Powers: A number of states have authorized insurers to engage directly in ancillary or supplementary and complementary insurance and financial services businesses. Limitations on direct business powers have forced insurers to use the more expensive subsidiary route to do indirectly what the law does not permit them to do directly.

Limited Subsidiary Powers: While state laws allow insurance companies to form financial services subsidiaries, they are heavily regulated and their investment authority is limited in a number of states to a relatively small percentage of assets. As a result, stock insurers form upstream holding companies. The upstream holding company, as a general business corporation, is not limited with respect to its legal authority to diversify. Insurance company holding companies, particularly mutual life and mutual property/casualty insurers, are, however, severely limited by restrictions on subsidiary investments. Accordingly, they lack competitive ability to diversify. Expansion of subsidiary investment authority as recommended by the Heimann Commission Report in New York (see Appendix B) and more widespread enactment of authority for mutual insurers to convert to stock companies might help alleviate such competitive inequalities.

Restricted Underwriting Powers: While stock insurers can generally write both non-participating and participating (dividend paying) policies, mutual insurers are limited to participating policies in some kinds of insurance in various states. Such pricing limitations often require that insurers use subsidiaries to do indirectly what cannot be done directly.

Other Needed Changes

In addition to the legal restructuring of the insurance industry, a number of other factors need to be addressed in order to facilitate the insurance industry's expansion into the financial services area.

One of these is the elimination of the outdated regulatory advantages of Blue Cross/Blue Shield. A "level playing field" is needed between commercial carriers and the Blue Cross and Blue Shield organizations. The Blues have substantial competitive advantages over commercial carriers. Their tax and regulatory advantages are no longer justified and should be eliminated. This is particularly true in the areas of discounts, tax exempt status and fixed prices that allow the Blues to pass the annual "cost-shifting" burden to private insurers ($4.8 billion in 1981) which are forced to pick up this gap in Medicare and Medicaid reimbursement shortfalls to hospitals.

Unfair competition from government financed health care should be eliminated. Again, a level playing field is needed between private insurers and the federal government as insurers enter the new financial services arena. Cost-shifting in Medicare and Medicaid must be eliminated. Also, the eligibility for coverage under government programs and the escalation of government programs which may be unsustainable by our economy must be reconsidered.

Inflation, fueled by deficit spending at the federal level, must be curbed. It has caused numerous problems which put the insurance industry at a competitive disadvantage. It has caused increases in policy loans, surrenders and replacements, as well as lower margins in individual life lines, group health losses and fierce competition resulting in thin margins in group annuity lines. Inflation also is largely responsible for deficits in underwriting results for property/casualty insurers and for their severely impaired ability to raise capital.

The insurance industry also must develop its electronic data processing capacity and group marketing systems for efficient, low cost delivery of all lines of insurance and financial services to consumers. It also must train insurance and financial counselors who are capable of advising customers on the merits of all types of insurance and financial services available in the marketplace. Further, the insurance industry needs to anticipate legislative activities of other industries and plan its response, as well as develop its own plan of action.

Section IV

Banks and S & L Restrictions

Other industries point to several additional laws as impeding their efforts to provide a whole line of financial services.

A. **The National Bank Act of 1864**

This Act governs the operations and powers of national banks and restricts their activities to the business of banking. The Act does not expressly define the business of banking, but enumerates permissible activities that have been traditionally connected to banking. The Act also provides that a national bank shall have power to exercise "all incidental powers as shall be necessary to carry on the business of banking." In 1916, Congress amended the National Bank Act to specifically authorize national banks located in towns of less that 5,000 population to act as an agent for any insurance company licensed in that state. Federal courts have interpreted this provision to mean that national banks have no power to act as insurance agents in places of over 5,000 population. While the National Bank Act limited the activities of national banks, it did *not* limit the activities of bank holding companies. As of 1933, bank holding companies were selling insurance as part of their general banking functions.

B. The Bank Holding Company Act of 1956

As originally enacted in 1956, this Act limited the non-banking activities of multi-bank holding companies. However, it did *not* limit the non-banking activities of one-bank holding companies. As a result, many one-bank holding companies aggressively expanded their insurance and other non-banking operations during the 1960s. Between 1956 and 1970, the Federal Reserve Board, which is the regulatory authority that governs bank holding companies, granted approximately 40 applications for one-bank holding companies to engage in non-banking activities. Most of these involved insurance agency activities. In 1970, the Bank Holding Company Act was amended to eliminate the distinction between one-bank and multi-bank holding companies, making them equal under the Act and the Federal Reserve Board's regulations. However, the 1970 Amendments also amended Section 4(c)(8) to provide that a bank holding company may own the stock of an entity which is engaged in a non-banking activity if that entity's activity is "so closely related to banking or managing or controlling banks as to be a proper incident thereto." After the 1970 Amendments were enacted, the Federal Reserve Board promulgated Regulation Y, which provided guidelines as to activities "closely related" to banking within the meaning of Section 4(c)(8).

C. Title VI of the Depository Institution Amendments of 1982

This Act, commonly known as the Garn-St. Germain bill, prohibits bank holding companies from selling or underwriting insurance except in strictly limited circumstances. It amends the language in Section 4(c)(8) of the Bank Holding Company Act which was added in 1970 to prohibit in most instances a bank holding company from providing insurance as a principal, agent or broker. These amendments were in response to a U. S. Supreme Court decision which upheld the right of bank holding companies to sell property/liability insurance when the Court refused to upset a decision of a federal appellate court. The U. S. Court of Appeals had found that the insurance business was "closely related to banking" and permitted three bank holding companies to sell credit-related insurance. This Act also provides that the activities of a one-savings and loan holding company and its non-savings and loan subsidiaries are restricted to those permissible activities for a multi-savings and loan holding company. The Act and the report on this Act sidetracked an impending move by the Federal Home Loan Bank Board to allow savings and loan service corporations to engage in insurance activities.

D. The Glass-Steagall Act of 1933

This Act passed in 1933 prohibits banks and savings and loans from buying, selling and underwriting securities. It also prevents any federal reserve member bank from affiliating with any other entity engaged principally in the purchase, sale or underwriting of securities. Finally, this Act also prevents insurance companies with broker-dealer subsidiaries from engaging in the business of banking.

Section V

Major Insurance Industry Concerns

While representatives of the property/casualty insurance industry have differing perspectives on the future of the industry and the integration of financial services, they note a few issues most often arising as paramount to insurers.

One of these can be termed the equal or level playing field. Insurers want to make certain that a level playing field exists among the various institutions seeking to compete in the insurance and financial services industry. Fair competition in this context has two aspects:

Deregulation – If banks or other financial institutions are permitted to engage in the business of insurance, the insurance industry must be permitted to directly engage in banking.

Regulation – All writers of insurance must be subjected to the same ground rules and regulations with regard to financial solidity, capitalization, surplus and reserve requirements, involuntary markets, policy and rate filings and guaranty fund contributions. The unfair and indiscriminate use of personal information collected in the credit review process for other functions is a related concern.

Insurers also are concerned that regulation at the state level continue and that regulators with expertise in the field continue to regulate. New competitors entering into the insurance business must also be regulated by the state insurance departments. Development of a "super regulator" or transferring the regulation of insurance to the federal government are unacceptable options. A related issue is insurer opposition to repeal of the McCarran-Ferguson Act, a proposal often raised in this context.

Different industries have a variety of financial safety nets. There are insurance guaranty funds in all states for property-casualty insurers and in many, but not all states, for life insurers. The solidity of the banking industry is guaranteed federally through the Federal Deposit Insurance Corporation (FDIC). Broker-dealer customers are protected up to $500,000 in securities and $100,000 in cash by the Securities Investor Protection Corporation (SIPC).

Would the combined capabilities of all these mechanisms be strong enough to withstand the insolvency of a major financial institution? In a case where one part of a financial conglomerate became insolvent, how would the liabilities be coordinated and allocated among the various mechanisms? For example, if a brokerage house that was merged with a casualty insurer and real estate firm went bankrupt, would the insurance industry guaranty fund pick up liabilities in excess of those covered by the SIPC or could the creditors touch the assets of the insurer or realtor? Could the creditors touch the loss reserves of the insurer? If the assets were required to be kept separate, would the advantage of integration be lost?

Insurers are required by state law to use statutory accounting practices (SAP), while all of the other financial services industries use generally accepted accounting principles (GAAP).

Tax Problems

The Internal Revenue Code provisions regarding the taxation of insurers are also tied to the insurance statutory accounting system. If and when integration occurs, will it be possible to allocate assets of the on-going concerns so as to distinguish the assets of each business? For example, a life insurer and brokerage firm that merge might have a common building, pension fund, library, employees, etc. If the brokerage firm went bankrupt, would the firm's books clearly indicate its assets and distinguish them from the life insurer's? This would require an accounting allocation which woud be difficult or impossible, particularly when the two businesses are using two different accounting methods.

Even if the assets can be segregated, does the requirement of segregation destroy the benefits of integration? A related issue is whether the insurance statutory accounting practices will be eliminated as integration occurs. As the industries merge, there may be pressure to use a single accounting system. Changes in the accounting practices will impact on all insurers regardless of their degree of financial integration.

At the federal level, life insurers are taxed quite differently from other financial institutions. If integration occurs, how will the resulting institution be taxed? For example, if a life insurer and brokerage firm merge with a bank that owns a travel agency, can it be said that the resulting firm is a life insurance company and should be taxed as such? Again, difficult accounting problems would arise in attempting to segregate the assets of the life company so that it could be taxed as a life insurer.

On the state level, the insurance industry generally pays premium taxes while other industries pay income taxes. Again, it will be difficult to segregate the assets for these different taxes. In addition, new financial products are constantly being developed that cross traditional industry lines. How will these products be treated for tax purposes?

Section VI

Insurance Industry Predictions

There are essentially three types of predictions regarding the future of the property/casualty industry.

Limited Impact — Some believe that the insurance business will continue with little change. Those who have this view point to the past attempts at full integration that have failed.

They also note that each industry is a demanding speciality with a considerable body of technical knowledge. Each serves a fairly distinct market. Banks, thrifts or stockbrokers are not likely to make significant inroads into the marketing of property/casualty insurance. Where linkage now exists between the fields, there is already a crossover. For example, in the financing and issuing of insurance on cars and homes, there has been for many years the sale of insurance by thrifts — and auto dealers — and in some cases, the availability of auto financing through insurers.

While returns for the property/casualty industry, viewed over the duration of the traditional underwriting cycle, are attractive and might attract other financial institutions into the business, the prospects for the industry are uncertain at present. Recent entrants into the property/casualty insurance business, such as major life insurers, have discovered they almost invariably operate in the red during their early years of business.

Property/casualty insurers are diversifying, but it's likely not the result of the belief that all financial services in the future will be filled through a one-stop, multi-service center. Diversification moves have been prompted by a growing realization that financial services is a good growth business. But no one has yet discovered how to integrate different business with varying business cycles into one entity.

It remains to be seen whether consumers are ready to shop at a one-stop financial services supermarket. The present merger of financial services seems to be generated by the *sellers* of the services and not the *buyers*.

Cross-selling new products to an existing consumer base is not easy. Sale of insurance through the Sears catalog has not been very successful, nor has the sale of Firemen's Fund insurance through American Express. The experiment to sell mutual funds through independent insurance agents also has not worked very well.

The insurance agent identifies with and tailors products to a customer's needs. The agent adapts to changing consumer practices in a way that a large financial conglomerate never could. Hence, there will always be a demand for such agents.

There are now multiple financial products to serve the consumer's every need. Added competition from other industries may not translate into better prices for the consumer. Thus, the consumer may not want additional products or services.

Major Changes Seen by Others

Others believe there may be only a few major financial cartels operating worldwide by the end of the decade. They anticipate that before long, the small and middle-size financial institutions and insurance companies will be "crowded out" of the market or seek shelter in a large conglomerate and the most efficient international corporations will dominate the market. The American insurance agency system will disappear, they say, as banks' service changes will be far smaller than a typical commission. While these financial giants may compete initially, the decrease in the market of a number of competitors to a few giants will lead to a monopoly.

Those who anticipate major and lasting changes with only a few major financial cartels operating worldwide by 1990 believe that a level playing field is not possible. They believe banks and holding companies will acquire insurance companies because of the banks' competitive advantages and efficiencies in operation that can be achieved. In turn, insurance companies will have to become more aggressive and increase their efficiency through innovative management and technology. Insurance companies also will acquire banks and use them as insurance distribution outlets.

Those of this view feel that these changes are inevitable for the following reasons:

Tie-in Sales — Banks will always have an unfair competitive advantage if allowed into the business of insurance due to their consumer marketing powers. Banks may be able to force tie-in sales by offering to insure homes and cars when they finance them, with the implied threat that credit will not be available unless the consumer buys insurance from the bank.

General Motors finances and insures cars. Banks do the same with auto and homeowners insurance. In fact, banks could also offer the consumer group credit coverage for both life and disability and offer decreasing term life insurance to cover the consumer's mortgage. What banks could do for individuals, they could do for groups, namely, group life, health and annuity coverage and group auto and homeowners. In short, some believe that a level playing field will never be achieved.

Unequal Access to Capital — Banks, as federally insured institutions, have a lower cost of funds than other enterprises. Banks could use these low-cost resources to subsidize non-banking activities, which would give banks an unfair advantage over insurers that must raise capital at ordinary market rates.

Profits — The property/casualty industry is large and profitable enough to attract other financial services businesses. The property/casualty business makes money in a variety of ways — on spread, float and fees. In addition, it offers other businesses the possibility of profiting in another way through use of their existing customer relationships. A major bank may well be prepared to absorb initial underwriting losses upon entry into the property/casualty industry. This may be a small initial price to pay for the funds and customer relationships gathered.

Equity — At the state level, legislation would be needed to implement federal legislation authorizing banks to exercise insurance powers.

Superficially, it would seem that equity could be achieved by giving insurers the reverse privilege, namely, existing banking privileges. In fact, the benefits would be unequal. Antitrust constraints would make it difficult for both large banks and large insurers to affiliate with each other. A small, nationally licensed insurer, however, could be leveraged quite easily into a substantial bank. Through the insurer's multi-state distribution system, the bank would reach potential customers well beyond its legal parameters. But if a large insurer were to acquire a small bank, there would be no comparable opportunity, because banks are prohibited by the McFadden Act of 1927 from operating a bank in more than one state. To achieve equity, insurers would need multi-state banking authority.

Other Unfair Advantages — Banks will have a huge customer base, local distribution system and advanced electronic communication capabilities in place upon their entry into other businesses. In addition, bank contacts with customers are far more frequent than those of insurers or securities firms.

Insurance Industry Will Survive

Somewhere between those who believe either no big changes or drastic changes are in the insurance industry's future are those who believe that companies currently well established in the financial services market, whether in banking, insurance or securities, will survive and continue to compete successfully against companies that attempt full integration. Mergers will get rid of excess capacity and make the industry more efficient and specialized. This will not necessarily lead to a full integration. Full integration will not be necessary for survival.

These experts point to the example of Sears, which has acquired a real estate and a stockbrokerage firm. Although Sears uses a common distribution system, both of the acquired firms have remained relatively autonomous and no real integration has occurred. The financial services system of the future will consist of multiple service specialists working within either a visible or invisible conglomerate structure. Individual companies will most likely retain their autonomy in such a structure and non-integrated, specialized firms will compete successfully against the conglomerate.

It is alleged that there are few economies of scale in the financial services industry that will entice firms to merge into giant financial services corporations. The economies that do exist are due to shared distribution systems. It is more likely that insurers will engage in joint ventures or in other arrangements with other financial services providers to capitalize on the unique functions of each of the parties while remaining relatively autonomous.

Consumers have become more affluent and attuned to investment alternatives. Consumers are pressuring financial institutions to provide more options. At least some consumers seem to be currently demanding one-stop financial services and are accepting automatic teller machines. This may indicate a willingness to purchase insurance from other institutions and through other methods than through an insurance company or agent.

Some mergers among insurers and other financial providers already are taking place.

Legislators currently favor deregulation and legislation repealing many existing legal barriers will likely be promoted, particularly on the state level, to attract new industry, create jobs and expand consumer choices.

Section VII

Responses of Other Industries

The Banks' Perspective

Banks advance a host of arguments for needing full insurance and securities powers. The following are some major themes:

(1) **Economic Survival** — Banks assert that they need expanded powers in order to survive and compete. Insurers and other types of financial institutions can

now offer a host of products which banks were once uniquely positioned to offer. Banks point to the new "separate accounts" of insurers, arguing that even the most sophisticated bank customers cannot see the difference between these and a bank trust operation.

A less recognized device is the administrative service contract under which insurance companies collect fees for performing deposit and withdrawal-type services for self-insured risks. More recently, insurers have been experimenting with Cash Management Accounts — the use of money market funds which they, but not the banks, can be authorized to underwrite and manage, as facilities for collecting premiums, maintaining customer funds, investing insurance benefits and making withdrawals. Banks stress that they must offer a wide range of services or they will not survive, even in areas of traditional banking service.

(2) **Level Playing Field** — The banks also argue that a level playing field is needed to give them the same range of access to the changing financial services market as other financial institutions. Since they are the most heavily regulated of the financial service providers, they point to the federal and state legal restraints on their interstate activities. The insurance and securities industries would have much broader authority to enter into other financial businesses, but for the banking laws. These groups are now engaging in "near-banking" activities — taking over many functions traditionally reserved for banks.

Moreover banking laws have fostered a regional and segmented industry, without a national marketing structure, while the insurance industry and securities industry have nationwide distribution systems in place. Therefore, regulatory barriers which prevent banks from offering the whole line of financial products and delivering them on a nationwide basis should be removed.

(3) **Existing Regulations Are Outdated** — Banks contend that the reasons that led to the existing legal impediments no longer pertain. For example, bank entry into the securities business was believed to be a cause of the Great Depression and this led to the Glass-Steagall Act. Other regulations and conditions now exist that make the Glass-Steagall Act outdated.

(4) **Customers Demand Expansion** — Bank customers are becoming more sophisticated and are demanding new and innovative products, which banks are now prohibited from offering.

Securities Industry's Perspective

Securities firms and investment bankers have mixed reactions to possible entry by banks, insurers and other financial institutions into their business. The following are issues raised in the securities industry:

(1) **An Equal Field** — The securities industry also wants a level playing field. They want banking powers if banks enter the securities business. Also, they believe banks should be subject to equal regulation. Currently, since the Glass-Steagall Act prohibits banks from selling securities, Congress exempted banks from regulation under all of the federal securities laws — Securities Act of 1933, Securities Exchange Act of 1934, Investment Company Act of 1940 and Investment Advisors Act of 1940. If banks enter into the securities business, these exemptions for banking must be removed. Also, the SEC's jurisdiction must be extended over existing "securities-type" activities undertaken by banks, such as bank-sponsored pooled investment funds for retirement plans and bank investment advice services.

(2) **Unfair Competition** — Although the McFadden Act and the Douglas Amendment require national banks to conform

with state branch banking laws and thereby technically prohibit interstate banking, banks still have developed a well-established distribution chain of local "affiliated" banks connected to large national banks. There are more than 14,000 banking institutions nationwide with more than 47,000 offices. This would give banks a nationwide system to distribute securities, if given the power. This advantage will exist even if securities firms are given existing banking powers, because of current limitations allowing securities firms to have only one bank in any state. To avoid the banks' unfair advantage, securities firms need multi-state banking privileges.

(3) **Availability of Funds** — Securities firms note that banks will be able to finance their non-banking activities with depositors' money, while money market funds and mutual funds will not be able to use shareholders' money to finance their new operations. Moreover, depositors' funds are federally insured. Finally, because they are federally insured, banks will be able to raise capital to finance non-banking activities at lower rates than the market rates that securities firms will have to pay. The securities industry also alleges that mutual insurers can use their surplus to fund non-insurance activities.

(4) **Tie-in Sales** — Banks are the principal source of commercial credit. Since virtually no commercial venture can exist without bank credit, banks will have a unique advantage when they "offer" securities to their borrowers. Trust powers also give banks an advantage in marketing individual estate planning, pension and related services.

(5) **Potential Abuse** — Securities firms point to past scandals in which banks have used depositors' funds to shore up an affiliate or a company to which the bank loaned money. If banks enter the securities business, they may well be tempted to use the proceeds of that business or force investment by others for similar purposes. Moreover, securities firms argue that it will be impossible for banks to impartially allocate credit throughout the economy if they enter the securities business.

(6) **Other Competitive Advantages** — The securities industry argues that banks have numerous other competitive advantages. The banks have an enormous customer base, penetrating all socio-economic classes, composed of checking, savings and time account depositors, corporate, commercial and personal loan clients, credit card holders and trust customers. Bank corporate loan personnel are much more sophisticated than brokers or insurance agents and could much more readily be trained to sell additional financial services.

(7) **Public Trust** — Securities firms believe that the protective regulatory framework that exists should not be undone amid the current economic turmoil and uncertainty. The remaining confidence that the public has in financial institutions should not be shaken.

Section VIII

Possible Regulatory Responses

Federal Proposals

The following are possible responses being made at the federal level:

(1) **Senate Bill 2490 - The Treasury Proposal** — The Reagan Administration proposed changes in the Bank Holding

Act and amendments to several other banking statutes which were drafted by the Treasury and introduced in Congress in June 1982. It is anticipated that these amendments will be reintroduced in the next session of Congress. The Administration/Treasury proposal would allow bank holding companies to become diversified financial service firms by engaging, through subsidiaries, in any activities the Federal Reserve Board determines by regulation to be "of a financial nature." Under this plan, the Fed is to give primary consideration to the "public benefits of increased competition between bank holding companies and other financial firms." Moreover, this proposal specifies certain activities in which a bank holding company subsidiary may engage, whether or not characterized by the Fed as "services of a financial nature." Among those specified activities are insurance underwriting and insurance brokerage. This proposal does *not* permit direct entry by banks into nonbanking activities. Only subsidiaries of bank holding companies may engage in these new activities, although banks will still be able to associate themselves with those firms that can now compete for customers. This proposal also requires that bank mutual fund activity be conducted through separate affiliates subject to SEC jurisdiction.

(2) **Senate Bill 1720** — This is Utah Senator Jacob Garn's proposal to deregulate banks and other thrift institutions. It contains a provision that would expand a bank's ability to engage in insurance agency activities. This bill would also directly modify Glass-Steagall and permit banks and thrift institutions to distribute all types of mutual funds. The bank-sponsored funds would be subject to the Securities Act of 1933 and the Investment Company Act of 1940.

(3) **SEC Proposal** — Chairman John Shad of the SEC has proposed a nonpartisan, multi-discipline task force to study regulatory reform of the financial services industry which would report its findings to Congress within one year. The task force would redefine competitive boundaries among financial institutions and the allocation of regulatory jurisdiction. The SEC proposal calls for the task force to study regulation by function rather than by industry or historical classifications. The task force would also consider consolidation of regulatory activities to decrease conflicting regulation and administrative costs.

(4) **The Administration Study** — The Reagan Administration developed a proposal to study the regulation of the financial services industry to replace the SEC proposal. Vice President George Bush would head the study and the study group would be staffed with Treasury Department officials.

State Proposals

The following are some of the initial responses at the state level:

(1) **National Association of Insurance Commissioners (NAIC)** — The NAIC formed a Task Force on the Integration of Financial Services at the 1982 Winter Annual Meeting last December. The task force was charged to study the problems related to the integration of financial services and recommend regulatory responses. The task force is still at the organizational stage and its direction is uncertain. It is likely however, that an advisory committee will be appointed and the Alliance has asked to be represented on that advisory committee.

(2) **South Dakota** — This year South Dakota amended its state banking code to permit federal banks to become state-chartered banks. Additionally, these banks may engage in the business of insurance, either directly or through a

subsidiary. Another newly enacted South Dakota law allows any insurance company, directly or through subsidiaries, to engage in all facets of the banking business. The legislation permitting banks to enter the business of insurance was effective immediately and the legislation allowing insurance companies to engage in the banking business is effective July 1, 1983.

(3) **Delaware** — Legislation to permit banks to enter the insurance business through subsidiaries also has been examined in Delaware. No bill has been introduced to date there, but proposals to allow banks to engage in the insurance business have the support of the governor of Delaware and the mayor of Wilmington. The governor and mayor believe that legislation such as that enacted in South Dakota would be the second step of a program they have initiated to make Delaware a center of finance on the East Coast. Legislation enacted in 1981 made Delaware more attractive for banking institutions generally, and laid the groundwork for the expansion of financial services.

(4) **New York** — New York appointed an Executive Advisory Commission on Insurance Industry Regulatory Reform in response to the change in the financial environment that insurers face. This commission is also referred to as the Heimann Commission (see Appendix B). The commission made recommendations for changes in New York laws and regulations regarding investments, corporate activities and accountability. The commission delivered its report on May 6, 1982, and on June 10, 1982, five bills were introduced in the New York legislature which would have implemented several of the commission's most important recommendations. These bills would:

- Make numerous changes in the investment provisions of the New York Insurance Code so as to give the management of an insurance company more discretion as to the quality and quantity of investments which may be made.
- Delete the current "ancillary" business restrictions imposed on downstream subsidiaries of insurers and permit a domestic insurer to invest in subsidiaries engaged in any lawful business, subject to a limit of 10% of admitted assets for subsidiaries and 2% of admitted assets for any single subsidiary, those limits being inapplicable to subsidiaries that are insurance companies, holding companies and investment management subsidiaries.
- Change the existing law to permit mutual life insurers to convert to stock companies.
- Require the filing of annual audited financial statements.
- Require that at least one-third of the members of a board of directors shall be persons who are not officers or employees of the company or its affiliates and require the establishment of one or more committees comprised solely of non-management directors to review the company's financial condition, nominate directors for elections, evaluate the performance of principal officers and make recommendations for their compensation.

The legislature recessed one month later without taking any action on these bills. However, these five bills were again introduced in the 1983 legislative session.

(5) **Connecticut** — A bill is under consideration in Connecticut which would allow commercial banks to sell life insurance policies and annuity contracts. It is not anticipated that this bill will be expanded to include property/casualty insurance. A similar bill has been introduced in Maine.

Section IX

Current Studies

A number of organizations have begun research on the new financial services industry and its impact on future competition and regulation.

American Council of Life Insurance (ACLI) — The ACLI established a committee of chief executive officers to review the future of the life insurance industry vis-a-vis other financial institutions. The ACLI recently released its report, which is divided into three parts. Part I describes the five major segments of the financial services industry: life insurance companies, banks, thrift institutions, securities concerns and finance companies. The powers and restrictions, current business activities, diversification prospects and competitive advantages and disadvantages of these five segments of the financial services industry are discussed. Part II focuses on the products and services available in the financial services marketplace. Part III suggests a number of areas which should be explored in order to develop a comprehensive legislative position for the life insurance industry.

American Insurance Association (AIA) — The AIA has retained Coopers and Lybrand to examine the economic, financial, regulatory and public policy implications for marketing and underwriting property/casualty insurance if deposit-taking institutions are provided additional authority to market or underwrite such insurance. The report is due out later this year.

American Bankers Association (ABA) — The ABA has performed a study to determine where banks might profitably expand their service offerings. The study focuses on areas where banks are prohibited from competing or where there is some legal questions about their ability to compete. This report may impact on the industry's legislative agenda.

Section X

The Future and the Issues

Several significant issues which the emergence of the new financial services industry poses are here summarized. Only the future can tell how and when they may be resolved.

Structure of the Industry — What type of institution will provide financial services in the future? Will financial conglomerates satisfy all the financial needs of the individual, or will there be a continuing need for specialists or agents? Are there antitrust restraints on the degree to which financial integration can proceed, such as vertical and horizontal mergers, tie-in sales and interlocking directorates?

Equal Playing Field — Will there be a completely equal playing field? Can all financial services compete on an equal basis? Will the integration of financial services lead to increased competition or lessened competition as a few organizations with existing competitive advantages garner up the predominant share of the market?

Regulation of Insurance — Who will regulate the new industry, the federal government, the states, or both?

Type of Regulation — How will the new industry be regulated? Will regulation influence changes in the industry and/or will these changes in the industry affect regulation?

Impact on Different Insurers — How will current changes in the financial services field affect insurers of different sizes?

Appendix A

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FINANCIAL DATA (all figures in millions of dollars)	American Express	BankAmerica	Citicorp	Merrill Lynch	Prudential	Sears	Transamerica
Revenues	7,800	13,112	18,258	4,590	13,200	29,180	4,280
Net Income	559	425	774	220	not comparable	735	182
Assets	27,700	120,496	128,430	20,940	62,500	34,200	9,000
Customers' deposits	5,700	93,208	77,359	3,930	—	2,300	400
Customers' Credit balances	1,200(1)	—	—	2,700	740	200	1,600
Money Market Funds	17,200	—	—	48,900	5,000	9,000	400
Commercial Loans	4,200	48,800	60,411	400	1,560	—	—
Consumer Loans	1,000	25,100	22,029	5,000	3,900	4,250	1,500

(1) Total assets under management $37 million

WHAT THEY DO	American Express	BankAmerica	Citicorp	Merrill Lynch	Prudential	Sears	Transamerica
Securities brokerage	●			●	●	●	
Securities trading	●	●	●	●	●	●	●
Cash management services	●			●		●	●
Investment management	●	●	●	●	●	●	●
Commodities brokerage	●			●	●	●	
U.S. corporate underwriting	●			●	●	●	
International corporate underwriting	●	●	●	●	●	●	
U.S. commerical banking		●	●				
International commercial banking	●	●	●	●			
Savings & loan operations			●			●	
Small loans offices		●	●			●	●
Credit card, charge cards	●	●	●			●	●

WHAT THEY DO	American Express	BankAmerica	Citicorp	Merrill Lynch	Prudential	Sears	Transamerica
Traveler's Checks	●	●	●				
Foreign exchange trading	●	●	●	●	●	●	
Leasing	●	●	●	●	●		●
Data processing services	●	●	●	●			
Property-casualty ins.	●				●	●	●
Life, health insurance	●			●	●	●	●
Mortgage insurance						●	
Mortgage banking	●	●	●	●		●	●
Real estate development	●				●	●	●
Commercial real estate brokerage				●		●	
Residential real estate brokerage				●		●	
Executive relocation services				●		●	●

Appendix B

The Heimann Commission Report

Former New York Governor Hugh L. Carey named a 10-member Executive Advisory Commission on Insurance Industry Regulatory Reform in October of 1981. The blue-ribbon panel was charged with the responsibility of formulating proposals to reform the state's 40-year-old insurance code. The commission issued a 112-page report containing more than 40 recommendations in May of 1982.

The commission, more popularly known as the Heimann Commission, was chaired by John G. Heimann, a former U. S. comptroller of the currency and New York state banking commissioner. Heimann is presently associated with an investment banking firm.

Other members of the panel included Maurice R. Greenberg, president and chief executive officer of American International Group, Inc.; Harold A. Eckmann, chairman of Atlantic Mutual Insurance Company; and Robert A. Sherman, a senior vice president of Eastman Kodak Company and a director of Aetna Life & Casualty Insurance Company.

One of the commission's major proposals called for repeal of state laws prohibiting insurers from offering claims and other administrative services to employers who self-insure their workers compensation risks. The report also recommended the expansion of insurance company authority in a number of other areas, including:

(a) Rendering investment advice.
(b) Rendering services which are related to the functions involved in the operations of an insurance business and which are reasonably complementary or supplementary to such business including, but not limited to, actuarial, loss prevention, marketing and sales, safety engineering, data processing, accounting, claims, appraisals, management and collection services.
(c) Acting as an administrative agent for a government instrumentality which is performing an insurance function for a health or welfare program.
(d) Acting as a trustee where so designated in connection with funds paid for or pursuant to any insurance policy or contract issued by it.
(e) Engaging in any other business activity reasonably complementary or supplementary to its insurance business, either to the extent necessarily or properly incidental to the insurance business the company is authorized to do in the state or to the extent approved by the director of insurance.

National Association of Independent Insurers

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John J. Nangle
ASSISTANT VICE PRESIDENT &
ASSISTANT GENERAL COUNSEL

June 21, 1983

Honorable E.J. Garn
Chairman
Senate Banking Housing and Urban Affairs
Committee
505 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Garn:

While questioning the agents panel at the June 7th hearing, you made the observation that non-banking type institutions are getting into the banking business and you asked the question whether or not they would require the banks to keep the traditional restrictions while everybody else rips off pieces of their business.

With your permission, we request that our answer to this question be submitted for the record.

Simply stated, the NAII does not consider the positions in conflict. Non-banking institutions avail themselves of avenues that exist in a regulatory and congressional void that are lawful and subject themselves to existing regulations. Banks are using a loop hole to get around the intent of the federal law. Non-banking institutions are merely positioning themselves before the train leaves the station while Congress can consider the matter. This is why we feel that the moratorium is so important. It would work both ways. Never has the purchase of insurance been conditioned on the making of a loan, however as we pointed out in our testimony, there is documented evidence that banks have actively and passively conditioned the making of a loan on the purchase of insurance.

Further, a bank is essentially a one-state operation. When a non-banking institution purchases a bank, they are more or less confined in their activities to that particular state or geography in that state. On the other hand, if a bank could purchase an insurance carrier no matter how small and limited in it's licensed territory, it could go nationwide.

Inherent in the question is the philosophy that what holds true for one must hold true for the other. I think that those of us who favor the moratorium are in fact acknowledging that this is a two-way street and that a moratorium is required to sort out all of the conflicting viewpoints and settle the regulatory problems that will arise.

Thank you for allowing us to comment on this question.

Yours very truly,

John J. Nangle

John J. Nangle

JJN/kst
cc: John B. Crosby

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June 21, 1983

Honorable E. J. Garn
Chairman
Senate Banking Housing and Urban Affairs
  Committee
505 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Garn:

During the testimony by the agents on June 7th before your Committee, you asked Mr. Nielsen how important he felt the McCarran Act was. Later you suggested that our industry was asking for federal pre-emption in the financial services area and that a careful watch on this suggestion is called for because others may be thinking about measures which could erode the McCarran Act.

First of all, I want to commend you for your stand on the McCarran Act and we feel as you do that it is essential to a vital and healthy property and casualty insurance industry in this country.

Our point is that we are not seeking federal pre-emption for anyone in this case. The bank holding companies are presently being regulated at the federal level by the Federal Reserve Board. The South Dakota action skirts the existing federal law and we feel makes a mockery of the intent of Congress as manifested in the Garn-St. Germain Act. Our point is that we seek only to plug this loop hole and disallow that which was never intended by law.

Thank you for allowing us to comment on this point.

Yours very truly,

John J. Nangle

JJN/kst
cc: John B. Crosby

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John J. Nangle
ASSISTANT VICE PRESIDENT &
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June 23, 1983

Honorable E.J. Garn
Chairman
Senate Banking, Housing
and Urban Affairs Committee
505 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Garn:

At the recent hearings on Conditions in the Financial Institutions Industry, the insurance panel of which I was a member was asked to comment on S.372, the Fair Insurance Practices Act. You, at that time, graciously granted leave for our Association to submit a written response on this important issue for inclusion in the record of the Committee's proceedings.

The National Association of Independent Insurers (NAII) is a trade association of over 500 companies which together insure forty percent of the automobile insurance market. We oppose S.372 which would pre-empt state regulation of insurance, destroy cost based pricing, and unfairly penalize women drivers.

By eliminating sex as a criterion on which all insurers may develop rates, Congress will have displaced the judgment of legislatures in all lines of insurance, in all fifty states, save but a few that have eliminated sex as a rating factor in automobile insurance. This is not a civil rights, or women's rights, issue. In fact, the impact of a "unisex" rating plan would be most dramatic, and adverse, for young female drivers. These young female drivers would immediately find themselves paying much more than they now pay for their auto insurance coverage. This is due to the fact the insurers could no longer charge females at rates based on their lower automobile accident potential.

Gender has been proven conclusively to be one of the best predictors of expected losses. Insurance industry data demonstrates beyond question that young male drivers have higher accident potential then young female drivers, and thus pay higher insurance premiums. The gender distinctions incorporated into auto classification plans reflect fairly and accurately the substantially fewer losses female drivers will have. Without the use of gender, sizeable over-charging of young women will result. The industry-wide data shows significant differences between male and female loss costs for young single drivers. These data show loss costs to be fifty-two percent higher for young men than young women. This would mean, if S.372 is enacted, that young female drivers would immediately be charged much higher insurance rates. They no longer would be rated in terms of their own potential for causing auto accidents, but would also be required to assume responsibility for a large portion of the accidents of young male drivers. In essence, young female drivers would be penalized, in the form of higher insurance premiums, for the auto accidents of young male drivers.

There have been suggestions that mileage could be used as a substitute for gender in rate determination. While there are in fact differences in the annual miles driven by males, as compared to females, careful analysis indicates that mileage is not an adequate or efficient substitute for gender. Although it is true that males drive more miles than females, and thus should be expected to have more auto accidents, when the mileage difference is factored out females still have fewer accidents than males. Thus, to achieve appropriate premiums for young male versus young female drivers, higher premium charges are still needed for the male drivers. There are other substantial limitations associated with relying on mileage as a reliable rating variable. For companies dealing with newly licensed drivers, there would be no history of miles driven on which to determine insurance rates. Premium amounts under these circumstances would be subject to nothing more than conjecture. Even among youthful drivers with one or two years' experience, there would be no way for an insurance company to termine accurately the mileage of the occasional driver, since the odometer reading merely registers the total mileage of the car.

Mileage is already being used as a rating factor in most classification plans. This is done through identification of the youthful driver as the principal or a non-principal operator of the vehicle. By identifying a principal operator, the industry is able to indicate the relative extent of his or her use of the vehicle in comparison to the mileage of non-principal users. In these plans mileage is not used as a substitute for gender; it is used in conjunction with it. To use mileage in this way, as a supplemental rating factor, recognizes the practical limitations of placing too much importance on mileage, as would be the case if mileage were substituted for gender.

Basically, policyholders are classified in relationship to the differences they exhibit in loss experience. These differences are reflected in the rates insureds are charged. Consequently, rates are a statistically accurate reflection of the real world. The industry does not classify according to ideology. Classification groups are identified by their similarities on automobile accident potential. When statistical relationships between classifications and auto are present, the industry reflects these relationships in equitable rates for similar types of insureds. As indicated, in auto insurance this classification system results in lower auto insurance rates for young women, higher auto insurance rates for young males.

-continued-

Sex discrimination in insurance is unlike anti-discrimination laws, which ban sex discrimination in employment, housing and credit, for these laws struck out an inaccurate and prejudicial stereotyping. However, it does not follow that every incidence of different treatment of the sexes amounts to unfair discrimination. NAII is very concerned about possible disruption and dislocation in the marketplace resulting from possible enactment of S.372. If an auto insurance company is forced to under-price a product, it will no longer have a financial motivation to sell the product to those who are under-priced. If an auto insurance company is forced by government to under-price youthful males, these males may find it difficult to purchase insurance from that company. By mandating a uniform rate for men and women, this proposed legislation would interfere with established economic laws of supply and demand. The uniform rate as applied to women would result in an over-charge, thereby creating a surplus of insurers and agents willing to write potentially profitable business. Conversely, the rate charged to men would be inadequate, thus providing a disincentive for insurers and agents to assume these risks. In short, there would be a surplus of suppliers for female insureds and a shortage of suppliers for the male insureds. Such an imbalance would only tempt government into further excursions into the marketplace, which history suggests would only cause additional problems.

The costs of S.372 to the purchasers of insurance are substantial. This is not well understood by the public and perhaps not by Congress. In terms of automobile insurance rates, the proposed legislation is clearly unfair to women.

Thank you for allowing us to share our views on this important subject.

Very truly yours,

Jack J. Nangle

John J. Nangle
Assistant Vice President and
Assistant General Counsel

JJN/sn

FINANCIAL SERVICES INDUSTRY—OVERSIGHT

Part II

WEDNESDAY, JUNE 8, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Hecht, and D'Amato.

OPENING COMMENT BY CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

This morning we continue the eighth day of hearings on the conditions in the financial institutions industry. We are honored to have before us today the first witness, the Honorable John Shad, Chairman of the Securities and Exchange Commission.

John, we're happy to have you here and please proceed.

STATEMENT OF JOHN S.R. SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. SHAD. Thank you very much, Senator Garn.

Chairman Garn and members of the committee, the regulatory scheme of the financial service industries should facilitate, rather than impede progress, promote fair competition and assure proper protection for depositors, investors, and the Nation. However, as a result of the accelerating rate of change in the banking, savings and loan, and securities industries, the present regulatory scheme is lagging further and further behind the marketplace. Disparities are increasing daily.

OCTOBER 1981 TESTIMONY

In testimony before this committee in October 1981—19 months ago—in support of amendments to the Glass-Steagall Act, it was noted:

That since the 1930's we have had regulation by industry categories, but new financial products and services, and major mergers and acquisitions have bridged the traditional gaps between the banking, savings and loan, and securities industries;

That regulatory conflicts and overlaps have multiplied, as evidenced by the fact that by the latest count 10 Federal and at least 50 State agencies, and over 20 Self-Regulatory Organizations

[SRO's] exercise jurisdiction over aspects of the financial markets alone;

And that competitive advantages increasingly turn on regulatory classifications, rather than on the economic merits of financial products and services.

FEBRUARY 1982 TESTIMONY

In February of last year, in testimony before the Securities Subcommittee of this committee, the foregoing observations were amplified, and a 1-year task force was proposed to assist and advise Congress on the simplification and rationalization of the financial regulatory structures, based on:

Regulation by functional activities, rather than by outmoded industry classifications;

Consolidation of related regulatory activities;

And elimination of excessive and conflicting regulations within and between agencies.

In January of this year, Vice President Bush formed such a task group. Important legislative initiatives are expected later this year.

ACCELERATING CHANGE

In the meantime, the rate of change in the financial service industries continues to accelerate:

Since last August, the strongest bull market in history has shattered all previous volume and other records.

Trading at an accelerating pace has commenced in new financial futures and options.

Just since December, as a result of the Garn-St Germain Depository Institutions Act of 1982, the Nation has witnessed an unprecedented movement of capital—over $380 billion into money market and Super NOW bank accounts.

Over $55 billion has moved out of the money market funds into such bank accounts, the stock market, and equity funds.

Several banks and thrifts have begun managing investing companies.

Hundreds of banks and thrifts have entered the discount brokerage field.

Securities firms are acquiring nonbank banks in order to offer trust services to pension funds and others, as well as federally insured money market accounts.

Merrill Lynch has proposed to add an S&L to its complex.

And several major banks have begun interstate banking through the mails, toll-free phone systems, and automatic teller machine networks.

Glass-Steagall and McFadden are being dismantled at an accelerating rate.

FAIR COMPETITION

We should not be lulled by the fact that the record trading volume and money market fund withdrawals have been handled without incident, and that so far investors and depositors have benefitted from the increasing competition. Competition should be fair and investor and depositor protections should be maintained. Banks, S&L's, and securities firms compete under different tax, regulatory and financing rules administered by different Federal and State agencies. For example:

Banks have the use of federally insured deposits and access to the Fed's discount window; competing investment, finance and other companies do not.

Broker-dealers can offer nationally an array of financial products and services; banks and thrifts have been subject to geographical and other limitations.

Banks are permitted to deduct for tax purposes the interest costs of carrying underwriting positions in tax-exempt general obligation bonds; competing underwriters are not.

Banks which provide brokerage service directly, rather than through separate corporate affiliates, are not subject to salesman supervision, customer suitability, and other rules, which are investor protections required of all others who offer such services to the public.

Bank-sponsored collective funds are not subject to as stringent disclosure, advertising, conflict-of-interest and other investor protections, as the investment companies with whom they compete.

These and other disparities can be largely resolved through:

Regulation by functional activities;

Consolidation of related regulatory activities; and

The elimination of excessive and conflicting regulations, within and between agencies.

The following proposals are in accord with such criteria.

1. MARGIN REGULATIONS

Margin regulations are presently administered by the Fed, the boards of trade and the securities exchanges, under differing regulatory schemes. Such regulations have a direct effect on competing financial instruments and an indirect effect on other markets. The Fed's staff is currently studying the margin regulations. One alternative would be to permit the SRO's to set their respective margin requirements, subject to oversight by a small committee, consisting of a CFTC and an SEC Commissioner and a Fed Governor, to assure the adequacy and conformity of such regulations. This alternative has not yet been considered by the three agencies or others.

2. SEC/CFTC COORDINATION

Some have proposed consolidation of the SEC and the CFTC, but it does not appear to be a political possibility or a practical necessity at this time. The SEC/CFTC jurisdictional accord enacted last year resolved certain major problems and set the stage for closer coordination of the two agencies' efforts. Remaining needs include:

The elimination of duplicative and overlapping regulations between the two agencies, upon which public comment is presently being solicited;

The coordination of their market surveillance, enforcement and public protection efforts; and

The elimination of differences in tax, margin, and other regulations applicable to functionally equivalent products.

3. SELF-REGULATION

In order to reduce duplicative, overlapping and conflicting regulations, paperwork and expenses, the securities and commodities SRO's should be encouraged to closely coordinate their efforts (perhaps by establishing a single entity) to monitor and inspect securities and commodity brokers and to refer violations to those organizations which have disciplinary and enforcement responsibilities.

4. SHAREHOLDER COMMUNICATION

Because of the high percentage of securities now registered in nominee names, the SEC has proposed simple procedures to expedite corporation's ability to transmit proxy and other materials to their shareholders. The proposals would require brokers to identify consenting clients to companies in which they hold securities and to transmit expeditiously materials to their client-shareholders.

While the Commission has the authority to implement such procedures within the securities industry, neither it nor the bank regulators have such authority within the banking industry. It is therefore requested that section 14(b) of the Securities Exchange Act be amended to require banks to perform the same functions as brokers under that section.

5. FULL DISCLOSURE

The Fed, Comptroller, FDIC, and FHLBB presently administer, under differing interpretations and requirements, the periodic reporting, proxy, tender offer, and short-swing profit regulations of 960 banks and thrifts under the securities laws, as well as all banks' and thrifts' issuance of securities.

The SEC administers these requirements for all other publicly owned corporations, including over 825 bank and thrift holding companies, which own and operate the Nation's 100 largest banks and 6 of the 10 largest S&L's. In the interest of efficiency and consistency of public disclosures and protections, it is recommended that these responsibilities be consolidated within the SEC.

Uniform disclosures are needed not only to enable investors to assess individual banks and thrifts, but also for comparative analysis of the risks and rewards of investments in various industry groups, such as banks and thrifts, as compared with securities, investment, finance, mortgage, and other companies.

6. SEPARATE CORPORATE AFFILIATES

As in the October 1981 testimony before this committee, enactment is strongly recommended of the Treasury's proposal to permit banks to underwrite municipal revenue bonds, sponsor and distribute mutual funds, and conduct their other securities activities through separate corporate affiliates, subject to the same rules, regulations, and tax treatment, as all other broker-dealers; and to permit broker-dealers that engage in no greater securities activities than those permitted the banks, to set up similar separate banking affiliates.

While this proposal should not be regarded as the sole means to protect depository institutions from risks that are incompatible with their special needs, it would provide regulation by functional activities and thereby resolve many of the problems previously cited.

The need for this functional legislation is greater today, than when it was originally proposed, 19 months ago.

Thank you.

[The complete statement follows:]

STATEMENT OF JOHN S.R. SHAD CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION, BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

June 8, 1983

Chairman Garn and Members of the Committee:

The regulatory scheme of the financial service industries should facilitate, rather than impede progress, promote fair competition and assure proper protection for depositors, investors and the nation. However, as a result of the accelerating rate of change in the banking, savings and loan, and securities industries, the present regulatory scheme is lagging further and further behind the marketplace. Disparities are increasing daily.

October 1981 Testimony

In testimony before this Committee in October 1981 -- 19 months ago -- in support of amendments to the Glass-Steagall Act, it was noted that:

- Since the 1930's we have had regulation by industry categories, but new financial products and services, and major mergers and acquisitions have bridged the traditional gaps between the banking, savings and loan and securities industries.
- Regulatory conflicts and overlaps have multiplied, as evidenced by the fact that by the lastest count ten federal and at least 50 state agencies and over

20 Self-Regulatory Organizations ("SROs") exercise jurisdiction over aspects of the financial markets.

- Competitive advantages increasingly turn on regulatory classifications, rather than on the economic merits of financial products and services.

February 1982 Testimony

In February of last year, in testimony before the Securities Subcommittee of this Committee, the foregoing observations were amplified, and a one-year task force was proposed to assist and advise Congress on the simplification and rationalization of the financial regulatory structures, based on:

- Regulation by functional activities rather than by outmoded industry classifications.
- Consolidation of related regulatory activities.
- Elimination of excessive and conflicting regulations within and between agencies.

In January of this year, Vice President Bush formed such a task group. Important legislative initiatives are expected later this year.

Accelerating Change

In the meantime, the rate of change in the financial service industries continues to accelerate:

- Since last August, the strongest bull market in history has shattered all previous volume and other records.
- Trading at an accelerating pace has commenced in new financial futures and options.
- Just since December, as a result of the Garn-St Germain Depository Institutions Act of 1982, the nation has witnessed an unprecedented movement of capital -- over $380 billion into Money Market and Super NOW bank accounts.
- Over $55 billion has moved out of the Money Market Funds, into bank accounts, the stock market, and equity funds.
- These cascading fund flows have caused violent reactions in the monetary aggregates.
- Several banks and thrifts, have begun managing investment companies.
- Hundreds of banks and thrifts have entered the discount brokerage field.
- Securities firms are acquiring "non-bank" banks in order to offer trust services to pension funds and others, as well as federally-insured money market accounts.
- Merrill Lynch has proposed to add an S&L to its complex.

- And several major banks have begun interstate banking through the mails, toll-free phone systems and automatic teller machine networks.

Glass-Steagall and McFadden are being dismantled at an accelerating rate.

Fair Competition

We should not be lulled by the fact that the record trading volume and money market fund withdrawals have been handlead without incident, and that so far investors and depositors have benefitted from the increasing competition. Competition should be fair and investor and depositor protections should be maintained. Banks, S&Ls and securities firms compete under different tax, regulatory and financing rules administered by different federal state agencies. For example:

- Banks have the use of federally insured deposits and access to the Fed's discount window; competing investment, finance, and other companies do not.
- Broker-dealers can offer nationally an array of financial products and services; banks and thrifts have been subject to geographical and other limitations.
- Banks are permitted to deduct for tax purposes the interest costs of carrying underwriting positions in tax-exempt general obligation bonds; competing underwriters are not.

- Banks which provide brokerage service directly, rather than through separate corporate affiliates, are not subject to the salesman supervision, customer suitability and other rules; which are investor protections required of all others who offer such services to the public.
- Bank-sponsored collective funds are not subject to as stringent disclosure, advertising, conflict-of-interest, and other investor protections as the investment companies with which they compete.

These and other disparities should be addressed in order to promote fair competition, assure proper protection to depositors and investors, and relieve unnecessary regulatory burdens. These and other disparities can be resolved largely through:

- Regulation by functional activities.
- Consolidation of related regulatory activities.
- And the elimination of excessive and conflicting regulations, within and between agencies.

The following proposals are in accord with such criteria.

1. Coordination of Margin Requirements

An example of regulatory disparities that distort competition is margin requirements for financial futures and options. The minimum margin requirements for traditional securities are now established by the Federal Reserve Board and the minimum margin requirements for new options products are set by the exchanges subject to SEC approval. By contrast, the commodity exchanges set the minimum margin requirements on futures contracts without being subject to approval by the CFTC or any other governmental agency. Since new products options and related financial futures are directly competitive, and because the level of margin represents a cost associated with participation in a market, differences in margin regulation can be an important competitive factor influencing market choice. As a result, the competitive advantages of these products may well depend upon their regulatory classification as a security or a future, rather than their economic merits.

The Federal Reserve Board's staff currently is reviewing the margin regulations. One alternative would be to permit the SROs to set their respective margin requirements, subject to oversight by a small committee, consisting of an SEC Commissioner, a CFTC Commissioner, and a Fed Governor, to assure the adequacy and conformity of margin regulations, so that similar financial instruments compete on their economic merits, rather than their margin requirements. This alternative has not as yet been considered by the three agencies or others.

2. SEC-CFTC

Regulation by the SEC and the CFTC of functionally similar instruments demonstrates the need to elinimate conflicting regulations. Instruments such as securities, options on securities, futures on securities, and options on futures are subject to different regulations, margin disclosure and other requirements. Because many of these instruments are functionally similar, the type of regulation to which they are subject can affect the competitiveness of these instruments.

Some people have proposed consolidation of the SEC and the CFTC, but this does not appear to be practically necessary or politically possible, at the present time. The SEC/CFTC jurisdictional accord enacted last year resolved certain major problems and set the stage for closer coordination of the two agencies' efforts. Remaining needs include:

- Elimination of duplicative and overlapping regulations of the two agencies, upon which public comment is presently being solicited.
- Coodination of their market surveillance, enforcement and public protection efforts and regulations.
- Elimination of differences in tax, margin, and other regulations applicable to functionally equivalent products under the two agencies.

3. Self-Regulatory Organization For Inspections

The securities and commodities brokers are subject to oversight and regulation by the SEC, the CFTC, over 20 self-regulatory organizations, and 50 state regulators. Most firms are subject to regulation by several SROs and others. Substantial progress has been made in reducing duplicative, overlapping and conflicting regulations and the attendant paperwork through the designation by the Commission of an examination authority for broker-dealers that are members of more than one SRO. Generally, the examining authority is the NYSE when the firm is a member of the NYSE and any other SRO. If the firm is a member of another exchange and the NASD, but not the NYSE, then the NASD is the examining authority. However, there continue to be duplicative examinations where the NYSE is the designated authority because the NASD also independently examines for compliance with its own rules related to the over-the-counter market activity and also for municipal security activity. In addition, duplicative examinations may occur where firms are dually registered as broker-dealers and futures commission merchants. Most of these firms are also subject to the compliance activities of state regulators.

In order to further reduce these burdens, the securities and commodities SROs should be encouraged to closely coordinate their efforts (perhaps by establishing a single entity) to monitor and inspect securities and commodities brokers and to refer violations to those agencies or SROs which have the disciplinary and enforcement responsibilities.

It should also be noted that H.R. 2681, which has passed both Houses of Congress and is awaiting action by the President, contains a provision, introduced at the request of the Commission, that would terminate the Commission's direct regulation of a small fraction of the broker-dealer community known as SECO broker-dealers. These broker-dealers are not members of a self-regulatory organization and are, instead, subject to comparable regulation by the SEC. The legislation requires SECO broker-dealers to join the self-regulatory system applicable to the vast majority of the industry.

This will remove a layer of government regulation, allowing the Commission to devote its resources to other purposes. In response to the proposal of this legislation, SECO firms that employ two thirds of the brokers of all SECO firms already have voluntarily joined a national SRO.

4. Shareholder Communications

One of the goals of the Exchange Act is the facilitation of communications between companies and their stockholders. In the last few years, however, the widespread use of nominee registration, which promotes the efficient transfer of securities, has had the collateral effect of interfering with such communications. While the Commission has authority to regulate the activities of brokers who hold their customers' securities in nominee name, neither it nor the bank regulators have the authority to regulate banks acting in the same capacity. This is particularly significant because substantially more than a majority of securities registered in nominee name are held by banks.

Under the Commission's current rules, brokers are required to disseminate proxy materials to stockholders for whom they hold securities in nominee name. Corporations for some time have expressed concern about the difficulties they have experienced in obtaining executed proxies for purposes of annual meeting quorums and extraordinary corporate transactions.

As a result of concern about nominee registration, Congress authorized the Commission to study the practice. Recently the Commission created an Advisory Committee on Shareholder Communications, composed of representatives of issuers, exchanges, brokers and banks. The Advisory Committee made certain recommendations, which included tightening the timetable for proxy dissemination and providing a means by which companies, at their own expense, can communicate directly with their beneficial owners. Last year, the Commission proposed certain amendments to its rules to implement these recommendations. These proposals would require brokers to identify consenting clients to companies in which they hold securities and to transmit expeditiously materials.

The Advisory Committee also noted that the current system is incomplete, because banks are not subject to Commission regulation under Section 14(b) of the Securities Exchange Act. Accordingly, it is recommended that legislation be enacted which would require banks to perform the same tasks that are required of brokers under that section.

5. Full Disclosure

Bank- and S&L-issued securities are exempt from the registration provisions of the Securities Act, leaving regulations of the issuance of such securities to the individual bank and thrift regulators and the states. In addition, the Fed, Comptroller, FDIC and FHLBB presently administer under differing interpretations and requirements the periodic reporting, proxy, tender offer and short-swing profit regulations of 960 banks and thrifts under the securities laws, as well as all banks' and thrifts' issuance of securities.

The SEC administers these requirements for all other publicly-owned corporations, including over 825 bank and thrift holding companies, which own and operate the nation's 100 largest banks and six of the ten largest S&Ls. In the interest of efficiency and consistency of public disclosures and protections, it is recommended that these responsibilities be consolidated within the SEC.

(a) Issuance of Securities - Securities Act of 1933

With respect to the issuance of securities, the differences between the SEC and the bank regulators generally are that:

- The SEC and the FHLBB require financial statements audited by independent accountants while the Comptroller requires audited statements only in limited circumstances and the FDIC does not require audited statements.
- The guidelines of the bank regulators regarding disclosures about a bank's financial condition, profitability, foreign and domestic lending activities and loan loss experience are not as detailed as those of the SEC.
- The Securities Act provides a carefully crafted structure for administration, remedies, and defenses.

Furthermore, there is inconsistency in the regulations of the various bank regulators pertaining to the issuance of securities. For example, the FHLBB's regulations governing the issuance of debt securities by thrift institutions specifically refer to SEC disclosure requirements, but the offering circular guidelines of the FDIC and the Comptroller's regulations governing the issuance of securities do not.

The appropriate remedy for this regulatory anomaly is to amend Sections 3(a)(2) and 3(a)(5) of the Securities Act to provide that equity, long-term debt and other investment type securities issued by banks and S&Ls be given the same treatment under the Securities Act as the securities of other issuers.

(b) Periodic Reporting - Securities Exchange Act of 1934

Under Section 12(i) of the Securities Exchange Act the bank regulators have independent authority to administer the periodic reporting and other provisions of the Act. In 1964, however, Congress amended Section 12(i) to require bank regulators to adopt regulations "substantially similar" to those of the SEC, within 60 days of adoption of SEC rules, unless the public interest requires otherwise.

Instead of promoting uniformity, Section 12(i) has produced a fragmented system with dissimilar disclosure requirements in securities of banks, thrifts, and other companies. Some of the differences in disclosure requirements are:

- Bank regulators (other than the FHLBB) do not require that financial statements in bank annual reports be certified by independent auditors. They accept financial statements that are verified by a bank financial officer or internal auditor.
- The SEC has established a Guide for Statistical Disclosure by Bank Holding Companies and is considering a similar proposal for S&L holding companies. This disclosure guide provides for analytical disclosures about a bank's financial condition, profitability, foreign and domestic lending activities and loan loss experience which is essential to investment decisions.

- The SEC requires annual financial statements to be prepared in accordance with generally accepted accounting principles ("GAAP"). Banks prepare their financial statements in accordance with GAAP modified for certain regulatory accounting principles ("RAP"), which may differ depending on the bank regulator. For example, the bank regulators' rules for recording intangible assets acquired in business combinations, such as goodwill, differ from the provisions for recording intangibles under GAAP.

These differences in disclosure requirements in prospectuses, offering circulars, and periodic reports create a lack of comparability between bank disclosures and those of other companies in the financial services industry and may result in confusion among investors. Financial statements prepared under the bank agencies' regulations can provide differing views of the financial condition of the bank or S&L depending on whether GAAP or RAP principles are applied and which agency is interpreting the rules. Bank financial statements also may lack the additional assurance provided by an independent audit. Moreover, the statistical disclosures required by the SEC in bank holding company filings are not required by the bank regulators in filings by individual banks.

* * *

Effective disclosures inspire investor confidence. Given these disparities, it may be diffcult for securities analysts and investors to evaluate the risks and rewards and reach reasoned choices among securities of banks and thrifts, finance companies, securities firms, investment, mortgage, and other companies. In sum, comparable disclosure requirements would facilitate such decisions.

Consolidation within the Commission of such bank disclosure in connection with the issuance of bank and S&L securities, by amending Sections 3(a)(2) and 3(a)(5) of the Securities Act and repealing Section 12(i) of the Exchange Act, would eliminate these disparities. It would consolidate regulation in one agency, eliminating duplicative and inconsistent regulation. Further, it would facilitate comparative analysis of similar investments by providing investors and analysts with more uniform disclosure.

The argument could be made that the SEC initially may have less expertise than the bank regulators in establishing appropriate disclosure requirements for banks and S&Ls. The Commission, however, has developed substantial expertise regarding the particular problems of banks and S&Ls in the course of developing and administering its disclosure requirements for bank and S&L holding companies. Thus, the Commission is capable of establishing workable disclosure requirements which reflect appropriate differences in these financial institutions. In this regard, the regulations of the FHLBB, under Section 12(i), generally incorporate by reference SEC regulations without special provisions for thrift institutions.

It should also be noted that in this time of concern with budgetary limitations, these actions would reduce duplicative staffs in the banking agencies. Similar changes in the Securities Act were made in 1976 and 1982 with respect to securities issued by certain railroads and bus companies subject to Interstate Commerce Commission jurisdiction without any adverse consequences.

6. Separate Corporate Affiliates

As in the October 1981 testimony before this Committee, enactment is again recommended of the Treasury's functional regulatory proposal to permit banks to underwrite municipal revenue bonds, sponsor and distribute mutual funds, and conduct their own securities activities through separate corpoate affiliates, subject to the same rules, regulations and tax treatment as all other broker-dealers and to permit broker-dealers that engaged in no greater securities activities than those permitted the banks, to set up similar separate banking affiliates. This proposal would provide regulation by functional activities. However, it should not be regarded as the sole means to protect depositary institutions from risks that are incompatible with their special needs.

The need for this legislation is even greater today, than it was when orginally proposed 19 months ago.

7. Uniform Regulation of Pooled Investment Vehicles

The regulatory schemes under which bank-sponsored collective investment vehicles and investment companies organized and sponsored by securities firms operate are substantially different. Some collective investment products offered by banks are subject to the federal securities laws; others are not. Those that are regulated exclusively under the banking laws are subject to standards that are not as meaningful as those of the federal securities laws. This disparity of regulation can be traced to the differing orientations of banking and securities regulation. Banking laws and regulations emphasize stability of banking institutions and protection of depositors' funds; securities laws and regulations focus on investor protection through full disclosure.

The significant distinctions in regulation are:

- Disclosure - Investment companies must file a detailed registration statement with the Commission and deliver a prospectus to purchasers. Other periodic reports containing balance sheet and other portfolio information must be sent to shareholders. National banks, however, are only required to file a written plan with the Comptroller and to distribute an annual report to investors upon request. Annual reports, however, do not provide the information essential for intelligent investment decisions.

- Advertising - Advertising is generally constrained under the Securities Act during the offering period and it is unlawful for any registered investment company to transmit any advertising material to prospective investors unless the material is also filed with the Commission. Banks are free to advertise investment funds for retirement accounts through methods that would not be permissible to common trust funds or registered investment companies; publicity concerning a bank's common trust funds is limited to making known the availability of trust services and distribution of its annual report.
- Investor Protection - The securities laws and the rules of the SROs contain specific provisions on suitability; conflict of interest transactions; independence of management; and limitations on advisory compensation. Although the banking regulations allude to the suitability concept, there are no specific banking analogs to these suitability and "know-your-customer" rules. Furthermore, the only requirement on conflict of interest transactions is that transactions involving trust accounts be fair and not prohibited by the trust instruments or local law. Employee benefit plan trusts are subject to the conflict-of-interest prohibitions of ERISA. There

are no specific provisions with respect to equal treatment of trusts under common management or best execution of trades by sponsoring banks. It has also been claimed that banks have left substantial funds from collective accounts under their management in non-interest paying accounts, which would be prohibited under the Investment Company Act. At the very least this raises questions about equality of regulation.

Nor do the provisions of the Investment Company Act designed to ensure the independence of investment company management have a parallel under bank regulations, since bank collective investment funds are not required to have separate boards of directors. Finally, the banking regulations contain no provisions for investor participation in approval of changes in fundamental investment policies as does the Investment Company Act.

In order to eliminate the regulatory anomalies that arise under the existing structure of regulation of investment management, it would be desirable to create a new regulatory scheme that would subject all collective investment vehicles -- common trust funds, pooled employment benefit plans, and investment companies -- to comparable regulation. The Treasury's separate corporate affiliate proposal provides an ideal first step in that direction. It should be extended to require that the management of all collective investment vehicles -- including common trust funds and pooled employee benefit plans -- be carried out within a separate corporate affiliate. The investment management activities of this affiliate would be subject to a regulatory scheme designed to be coordinated closely with the regulatory scheme applicable to investment companies not affiliated with banks. Complete identity of regulation would be impracticable, given the current differences in legal structure between investment companies -- which are normally in corporate form with a board of directors and shareholders -- and bank-managed collective investment vehicles -- which are generally in the form of trusts organized under state trust law.

It would nevertheless be possible to conform the regulation of the various types of collective investment vehicles in several critical respects. In the event that investment companies are allowed in the future to operate as unitary investment funds discussed below, bank common and collective pension funds could also be organized in this manner which would mitigate the objections of banks that it would be burdensome to have a separate board of directors. Additionally, the subsidiary of the bank holding company could choose to register the common and collective pension funds as investment companies under the Investment Company Act.

The regulatory provisions of the Investment Company Act, including those applicable to disclosure, advertising, investor protection and self-dealing, and limitations on advisory compensation, provide important protections to investors and the system works well. We have recently witnessed an unprecedented movement of capital out of money market funds without incident.

- The bank and savings and loan association new Money Market and Super-Now Accounts have grown from zero to over $380 billion; and
- Money market funds have declined $55 billion, or 24%, to $167 billion.

It may be possible to relax some of the more detailed requirements of the Investment Company Act without unduly jeopardizing investor protections. To that end, the Commission is presently studying the feasibility of the establishment of a new kind of investment company, the unitary investment fund just mentioned, which would not require a board of directors. Alternatively, the Commission is studying the feasibility of eliminating the requirements of shareholder voting in some cases. Shareholder voting provisions of the Act on such matters as changes of investment policies, and approval of advisory contracts and accountants, may result in excessive costs in relation to benefits, and could be eliminated without sacrificing investor protections. Changes to assure this result might include adequate advance notice of changes of investment policy, advisory agreements and management, provisions for shareholders referenda, and freedom to redeem shares without forfeiture of any previously-paid sales load or payment of a redemption fee.

We have also proposed for comment the possibility of creating one or more self-regulatory organizations to carry out investment company inspections.

8. SIPC

The protection of customer accounts under the Securities Investor Protection Act of 1970 has proved to be extremely useful in promoting investor confidence in the securities markets. For the last several years, the cost to brokerage firms of maintaining insurance has been nominal. Recent claims on the insurance fund have required an increase in assessments paid by brokerage firms. It may now be useful for SIPC to consider exercising its authority to establish risk-related assessments. Risk-related insurance premiums have also been proposed by the FDIC and others.

The advantage of risk-related assessments is, of course, its fairness to firms. Those that subject the insurance funds to the greatest potential expense would carry the highest Assessments. However, evaluating the risk for securities firms may prove difficult as there appears to be no clear risk pattern. The SIPC Board has considered risk-related assessments and rejected the concept as impractical to implement. However, SIPC is now studying free credit balances -- uninvested funds left with a broker-dealer upon which it may pay interest -- to see if there is a way to develop an objective standard for evaluating the risk they represent.

One important area which needs further attention is the delay in access to their accounts that customers experience when SIPC is liquidating a firm. The delay can be as short as one week but usually it is much longer. It may be impossible to achieve the turn-around that the FDIC can execute due to some inherent differences between the banking and securities industries, such as:

- FDIC's regulation of banks is substantive and pervasive. As part of this regulation it inspects banks on a regular basis. On the other hand SIPC, has no regulatory authority, and consequently does no inspections.
- Failed banks usually have good records; failed broker-dealers often do not.
- Bank customers only have a claim for cash whereas a brokerage firm's customer usually have a claim for securities and cash. Where customer securities are involved, SIPC is required to return securities and not the cash value, which involves the time-consuming process of determining the owners of stock held in street name and obtaining certificates in the proper denominations.

I believe the delays can be shortened, although it will probably require an increase in expenditures and manpower for SIPC. As part of its review of the SIPC program, the Commission is currently studying this area.

Thank you.

The CHAIRMAN. Thank you, Chairman Shad. We appreciate your testimony very much.

VIOLATION OF GLASS-STEAGALL

As I'm sure you're well aware, the FDIC has published for comment a rule which would permit State chartered nonmember banks to underwrite and deal in corporate debt and equity. The FDIC argues that this would not be a violation of Glass-Steagall. It's certainly a violation, at least in my opinion, of the spirit and intent of Glass-Steagall.

Do you concur with the FDIC or what do you recommend the Congress do in response to the FDIC's action?

Mr. SHAD. I think that it does violate the intent of the Glass-Steagall Act, and the concept of it. I think that there are very fundamental business risks that it poses that I don't believe have been addressed as yet.

The proposal includes underwriting investment grade debt and best efforts equity offerings. Investment grade debt is a keenly competitive area. Gross underwritings spreads are typically less than one percent. Modest declines in the market have resulted in huge losses by the underwriters because these offerings are typically not fully subscribed. The underwriters oftentimes have sold maybe 30 percent, 40 or 50 percent, and the balance they've had to either sell or own; it would not take a significant movement in the market during that period when they have large unsold positions to more than wipe out the fraction of 1 percent gross spread that they're working against. There have been many instances where the underwriters have taken multimillion-dollar losses in these offerings.

So the classification of investment grade debt sounds so-called riskless, but it's far from riskless because of the keenly competitive nature of the investment banking business.

In the case of best efforts equity offerings, these are obviously done by the most speculative and marginal companies. I question whether or not the banks should be publicly identified, directly or indirectly, with such companies because a lot of them fail. When they do, the underwriters of those offerings are frequently sued by the investing public because of the subsequent failure of those businesses on the issue of whether or not they have acted with due diligence.

Also, I question the practicality of the concept from the point of view of the ability of the banks involved to really do the distribution job. You're really appealling to the two extremes of the securities market, investment grade debt on one end, and very speculative securities on the other end. Investment grade debt is almost entirely sold to major institutional investors and that, again, is a keenly competitive market.

The other is a retail type product sold oftentimes to very unsophisticated investors, unfortunately, and I question whether or not this would be any kind of a real benefit to these banks.

It would also be a disservice. When you do a public offering, whether best efforts or not, of equities, it's an implicit obligation without it being a legal requirement of the managing underwriter and the participating underwriters to make markets in those securities. The public expects to get a readily marketable security. Certainly people are going to be very reluctant to buy securities without an after market. So if these banks engage in this activity, they could certainly be expected to be making an after market, which means acting as a principal and buying and selling these securities, and that exposes them to additional market risks.

So I've said much too much on this, but I wanted to make the business points. And it seems to me this is an area which demands congressional review rather than purely administrative agency action.

The CHAIRMAN. Well, I would agree with you. I said at the time the rule was published for comment that without regard to the merits or demerits, that it simply was not the kind of decision that I felt the FDIC or any other regulatory agency should make; it's a legislative decision. The purpose of these hearings is to take a look, an overview, of the entire spectrum of what's happening in the financial institutions and that whatever decision is made should be made by the Congress and not by the FDIC.

I still feel very strongly that way, that although it is probably not a technical violation of Glass-Steagall, that it does do violence to the intent. If we're going to make that dramatic a change it should be made by the Congress and not by rule of a regulatory agency.

SOUTH DAKOTA PREEMPTED FEDERAL LAWS

It has been said that the South Dakota State Legislature has preempted the Federal laws surrounding the insurance activities of bank holding companies and many argue that this has done violence to title VI of Garn-St Germain. The same pattern emerged—you could see it happening—in the 1920's.

Since Congress will obviously not take action very quickly on a comprehensive bill, do you recommend that Congress at least take action to curb individual States in situations like that?

Mr. SHAD. This is an area that is outside of any jurisdictional responsibility of the SEC.

The CHAIRMAN. I realize that.

Mr. SHAD. So it's a stretch for me to express an opinion about how this should be handled. I think that I'd be better qualified to respond in those areas that are closely and directly related to the SEC's responsibilities.

The CHAIRMAN. I understand the jurisdiction and I often like to ask questions of people who are in different areas. Sometimes their opinions are better than those who work daily with the problem. They're so immersed in their own individual areas of jurisdiction that sometimes their opinions are not as good as someone from an outside viewpoint.

Mr. SHAD. Based purely on my reading of the newspapers without the benefit of any of the Commission staff spending time in this area that I'm aware of, it does suggest there could be a dramatic shift of the way people do business. It's so simple to move your domicile, your State of incorporation to these States which are permitting everybody to enter into the field, and it seems to me that we're looking at a rapidly moving target of changing ways of doing business, of crossing over all the industry lines. I don't think that we need a dam, but I do think we need an opportunity to make sure that we're going to end up with adequate protection for investors and depositors and policyholders and the Nation, and that we end up with fair competition. I think that those are the prices that are being paid today. It's an increasing rate of change, and it is the problem of the time and effort that it requires for congressional action. It's unfortunate. I don't like to suggest impeding progress, but I certainly think that it ought to be within a reasonable and consistent regulatory structure, because I really do believe we need to protect investors and depositors and policyholders. And I really do believe that competition should be fair, and I don't think it is under this rapidly changing chain of events.

The CHAIRMAN. Don't ever hesitate to express your opinions based on what you read in the newspaper. Everybody else does. In fact, this morning I shared a level of knowledge I heard on the radio coming to work. There was a poll conducted in the Washington area that showed that only 22 percent of the people could state which side the United States was supporting in El Salvador. So feel free to express your opinions.

Mr. SHAD. Since I came to Washington, I have much greater reservations about what I read in the papers than I used to have.

BANK UNDERWRITING OF CORPORATE DEBT AND EQUITY

The CHAIRMAN. In your testimony you recommend that banks be permitted to underwrite municipal revenue bonds and mutual funds as long as the activities are conducted in a separate affiliate. That is consistent with Secretary Regan's recommendation before this committee for the last 2 years. And if this were a test that was successful, if we went that far, do you believe this would lead to bank underwriting of corporate debt and equity?

Mr. SHAD. Not necessarily, but there are a lot of fundamental problems posed by that prospect. Mr. Isaac and the FDIC have addressed many of the problems in their proposal, which I just said a moment ago I think requires congressional action. But I think there are four approaches that would have to be considered.

The problem is, I think, conflicts of interest and tie-ins. The justification of Glass-Steagall in large measure was the fact that the banks were performing all these multiple functions, sometimes with at least alleged serious conflicts by doing bailout financing of their own short-term loans with long-term debt offerings to the investing public and putting unsold underwriting positions into their trust accounts of soft offerings in a bad market. Those are outrageous allegations, if they're true, and that's the basis I think on which Glass-Steagall was passed.

So I think you've got to continue to deal with even the perception or the possibility of such a thing. There are four alternative ways of doing it perhaps. First, prohibiting any such transactions where a bank is doing business with a company. It can only have one relationship. It can be a depository. It can be a lender. But it can't be a depository, a lender, a transfer agent and registrar or trustee and an underwriter of their corporate debt. There are just too many invitations to conflicts and tie-ins.

Another alternative rather than prohibition would be a theory of a Chinese wall, which you have in the securities industry, between the brokerage and the investment banking side. It wouldn't look like a straight wall. It would have to have a lot of curves and special niches in it.

The **CHAIRMAN**. So does the Chinese wall, and a lot of breaks, too.

Mr. **SHAD**. I would say even higher and longer than the Chinese wall, which I understand is the only thing you can see from the Moon on the Earth.

The third is requiring so-called arms-length transactions which I don't think are practical alternatives. And the final—the SEC hasn't given this serious consideration—would be disclosure—using the public disclosure to make sure that everybody was aware of any banks engaging in these types of activities.

But these, I think, are very premature even to be discussed because I think the first judgment should be that of Congress as to whether or not this is desirable.

The **CHAIRMAN**. Thank you. Senator Hecht.

DIRECT BANK BROKERAGE SERVICES

Senator **HECHT**. Mr. Shad, you've got one paragraph on page 5 which capsules everything and, with your permission, I will quote you on this from time to time. I think it's great:

> Banks which provide brokerage service directly, rather than through separate corporate affiliates, are not subject to salesman supervision, customer suitability and other rules; which are investor protections required of all others who offer such services to the public.

Mr. **SHAD**. That's true.

Senator **HECHT**. Now we can continue right on down the spectrum. Do you feel that would be the same way in the insurance industry?

Mr. **SHAD**. Yes.

Senator **HECHT**. Real estate?

Mr. **SHAD**. Yes.

Senator **HECHT**. Title companies?

Mr. **SHAD**. Yes. I don't see any reason to qualify it.

Senator **HECHT**. Land development companies?

Mr. **SHAD**. Yes.

Senator **HECHT**. All of these the banks have been wanting to get into.

Mr. **SHAD**. Right. Let me say that the SEC doesn't have jurisdiction over some of the areas you mentioned. So that the SEC's investor protection requirements would not apply to any of those other areas. I should have qualified my yeses with that.

Senator **HECHT**. I appreciate your frankness and certainly you have expertise in these other areas.

Mr. **SHAD**. Well, in the others we're in related type activities, limited partnerships for the purpose of real estate financings and so forth. There are a lot of areas that do overlap—the SEC is very much involved in some forms of insurance contracts which we believe are securities.

So I would say that almost without exception the items you mentioned there would have some degree of SEC involvement. And if they were within the securities law, they would have the protections that you cited.

Senator HECHT. Well, however, certain proposals which would open up floodgates would not have these protections.

Mr. SHAD. That's true, without separate corporate affiliates, very definitely—that is, if banks were permitted to do these activities within the bank. The banks are specifically exempted under the Securities Acts from being required to comply. They're exempted from the definition of a broker-dealer, which is the basis of the SEC's jurisdiction.

Senator HECHT. Let's go one step further. Would the public be better served or less served if the banks were to get into this?

Mr. SHAD. Well, I believe that there would definitely be greater risks for the investing public. In terms of the risk or reward, the costs versus the benefits, I think that the public would be better served to have all of these activities within separate corporate affiliates and some of them—I'm sure other regulators in insurance and the banks—the banks already have the banks—but other regulators would probably argue that the insurance activities ought to be within an insurance affiliate where you have all the state insurance regulation coming to bear on the activity rather than in some exempt type vehicle that isn't subject to the same rules and regulations as all the people with whom they compete.

Senator HECHT. You get to the point real fast. I won't take up any more time. Very good. Thank you.

Mr. SHAD. Thank you.

Senator HECHT. Thank you, Mr. Chairman.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Thank you very much, Mr. Chairman.

DIFFICULTIES IN COMMUNICATING WITH SHAREHOLDERS

John, on page 8 of your testimony you refer to the difficulties corporate management has in communicating with shareholders. I know this has been a concern of yours for the last 2 years.

What proposals do you make? Do you need legislative authority to deal with this problem?

Mr. SHAD. Well, we have put out a proposal for public comment and we've had substantial favorable public reaction to it. It involves two things. One is just getting communications out more expeditiously by the securities firms in a shorter time span. But the biggest problem corporations have is they oftentimes can't get a quorum for an annual meeting through their normal mailings and they have to keep paying people to go out and solicit proxies because such a high percentage of securities are registered in nominee names.

Senator D'AMATO. So you're saying that corporations are having difficulty communicating with their stockholders?

Mr. SHAD. Exactly right.

Senator D'AMATO. OK. What are you going to suggest specifically to deal with it?

Mr. SHAD. The first and simplest step is to permit broker-dealers to identify to the corporation their clients who hold the securities even though they're in a nominee name. That would be with the client's consent. There are some investors that may not want the issuer to know their identity.

Senator D'AMATO. You're talking about broker-dealer identification of clients with the clients' consent?

Mr. SHAD. Right, to the issuer so they can communicate directly.

The other is the time requirements. Now the problem is that in many instances over half of a company's securities are in nominee names, and of that nominee portion, the banks have a larger portion of it than the brokers do. Neither the SEC, nor the bank regulators, have the authority to require the banks to adopt these expedited procedures. So that's why we proposed the amendment.

Senator D'AMATO. Are you proposing legislation?

Mr. SHAD. Yes, sir.

Senator D'AMATO. To require the banks to make the same information available?

Mr. SHAD. Do the same thing as the brokers.

Senator D'AMATO. Provided that the client has no objection to being identified?

Mr. SHAD. That's correct.

Senator D'AMATO. Has your response from the brokers and from the general public been good?

Mr. SHAD. Yes, but if you'd like more specificity I would ask Lee Spencer, the director of the Corporation Finance Division, to tell you what the reaction has been.

Mr. SPENCER. Good morning, Senator. We've had substantial and unusually large response, particularly from business corporations. Nearly 300 corporations wrote to us favoring these proposals, as also did some shareholders and other persons interested in the field.

To be fair, there was a concern from a relatively small number, but an identifiable number, of broker-dealers who worry about the cost involved in particular of a mechanism of transferring their clients' names to the business corporations. Ultimately under our proposals, however, the cost would be borne by the issuer, not by the broker-dealer. We're in the process of discussing and disseminating the comments and be prepared to have our recommendations to the Commission within the month.

Senator D'AMATO. What have the banks said about your proposed legislation?

Mr. SPENCER. Because we only propose our rules which wouldn't be legislation, we do not have a particularly large response from the banks on that issue. Of course, we wouldn't have proposed legislation for comment.

I think banks normally have not favored more regulation, so I think you would expect that there would be some concern expressed just as a practical matter.

Mr. SHAD. I think the important thing is that there is an economic cost, but the issuers are willing to pay it. The banks don't like to have to handle this, but they don't like the present arrangement either where they get a large volume of reports that they have to restuff and mail.

Senator D'AMATO. Well, I think our Securities Subcommittee should monitor this and if necessary consider the possibility of holding a hearing on that, Mr. Chairman. It's a valuable and important tool, something that makes economic sense, and I'm certainly interested in that.

Section 23(A) of the Federal Reserve Act which regulates transactions between bank holding companies and affiliates was amended last year as you know in the Garn-St Germain Act. In your opinion, is 23(A) sufficient to govern transactions between the bank and its securities affiliates? Do you think 23(A) offers adequate protections from tie-in arrangements?

Mr. SHAD. Senator, I'd like to give you a considered response on that. May I respond in writing after this hearing because I'd like to carefully review it in case we do have any qualifications. My immediate reaction is that it does handle it and I'm not aware of problems, but I haven't carefully reviewed it.

[Information subsequently supplied for the record follows:]

MEMORANDUM

August 8, 1983

TO: Chairman Shad

FROM: Office of the General Counsel Dan Goelzer

RE: Questions Posed by Senator D'Amato at Oversight Hearing on the Financial Institutions Industry

This memorandum sets forth supplementary responses to several questions posed by Senator D'Amato at the June 8, 1983 Senate Banking Committee oversight hearing on the financial institutions industry. Senator D'Amato's questions are set forth below, together with this Office's responses.

QUESTION 1: "Section 23(A) of the Federal Reserve Act which regulates transactions between bank holding companies and affiliates was amended last year as you know in the Garn-St Germain Act. In your opinion, is 23(A) sufficient to govern transactions between the bank and its securities affiliates? Do you think it offers adequate protections from tie-in arrangements?"

ANSWER

1. Bank/affiliate transactions

As the Committee is aware, Section 23A, which applies to all FDIC-insured banks, places certain restrictions on transactions involving banks and their affiliates. In general, Section 23A limits bank transactions with any single affiliate to 10 percent of bank capital and surplus and limits transactions with all affiliates to 20 percent of bank capital. Covered transactions include loans to affiliates, investments in affiliates, purchases of assets from affiliates (including assets subject to a repurchase agreement), loans to any person collateralized by securities of affiliates, and issuances of guarantees and letters of credit on behalf of affiliates. Section 23A also requires that all extensions of credit to affiliates be fully secured. These provisions, apparently designed primarily to ensure bank safety and soundness, are not adequate to address problems of conflicts of interest. However, S. 1609 attempts to remedy this deficiency by adding a new Section 23B to the Federal Reserve Act.

To the extent that banks conduct their securities activities through separate corporate affiliates fully subject to regulation by the Commission, some provisions of the securities laws would operate to augment the provisions of Section 23A. For instance, under the Investment Company Act, a bank acting as an investment adviser to an affiliated mutual fund would be prohibited from causing the fund to purchase its own certificates of deposit. But the Investment Company Act generally would not apply to bank common trust and collective funds, which commonly purchase the CD's of their managing banks, thus providing a ready source of funds for the banks.

Despite extensive revision by the Garn-St Germain Act, Section 23A was not drafted to deal comprehensively with the kinds of problems that could arise in transactions involving banks and their affiliates engaged in securities activities. 1/ Some of the recent amendments were designed to provide additional protections in the securities area. For example, one change expanded the definition of "affiliate" to include an investment company for which a bank or its affiliate acts as investment adviser. Nevertheless, especially if bank affiliates are given expanded securities powers, Section 23A is inadequate to address the unique problems raised by transactions involving them and the bank. In sum, even as augmented by the securities laws, Section 23A requires amendment to (1) specify a more appropriate standard applicable to conflict of interest transactions and (2) expand the scope of covered transactions.

The authors of S. 1609, the Treasury Department's proposal to expand the range of securities activities of bank-related organizations, recognized that the restrictions of Section 23A should be supplemented if bank affiliates are given expanded securities powers. 2/ As mentioned above, the

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1/ Of course if bank subsidiaries (as opposed to non-subsidiary affiliates) are permitted to engage in securities activities, as some have urged, a whole new set of problems is raised. Section 23A generally does not restrict transactions involving a bank and its subsidiaries.

2/ The comments on S. 1609 in this memorandum are not intended to represent a full discussion of the issues raised by the bill. We may make additional comments on the bill at the appropriate time.

Treasury proposal would add a new Section 23B to the Federal Reserve Act to supplement the provisions of Section 23A.

S. 1609 would require that certain transactions involving a bank and its securities affiliates be on substantially the same terms as those for comparable transactions involving nonaffiliated companies, or at least as favorable to the bank as comparable transactions. This is in contrast to the present standard in Section 23A, which requires that transactions be on terms that are "consistent with safe and sound banking practices." The difference between the two standards could be significant, for example, in situations in which a bank trust department directs brokerage business for its trust accounts to a brokerage affiliate. Under the present standard, the affiliate might charge the bank higher execution fees than it charges others for similar transactions. Arguably, this would not be inconsistent with safe and sound banking practices because the affiliate's higher brokerage profits would not impair the bank's safety or soundness, and might even inure indirectly to the benefit of the bank. S. 1609 would deal with this by specifically covering "transactions in which an affiliate acts as agent or broker," and by requiring the affiliate to charge comparable execution fees.

Also, S. 1609 would expand covered transactions to include, in addition to those discussed above that are now covered by Section 23A, sales of assets to an affiliate (including assets subject to a repurchase agreement) and payments of money or furnishing of services to an affiliate.

The bill would prohibit banks and their securities affiliates from publishing any advertisement suggesting that the bank is in any way responsible for the obligations of its securities affiliate. S. 1609 makes clear, however, that this provision would not restrict the use of similar names by banks and their securities affiliates. This, of course, is a controversial issue. In resolving this issue, Congress should consider the experience of bank-sponsored real estate investment trusts in the mid-1970's. When these entities experienced financial difficulties, public identification of the banks with their similarly-named REITs was so complete that many banks used their own resources to try to save REITs they had sponsored from failure -- at least in part -- in order to protect the bank's reputation and maintain confidence in its financial soundness.

S. 1609 also would add certain fiduciary responsibilities to the requirements of Section 23A. A bank could not purchase as fiduciary from a securities affiliate any securities or other assets unless the purchase is allowed under the instrument creating the fiduciary relationship, by court order, or by local law. This standard may be overly permissive, however, because it could be circumvented quite readily by inserting boilerplate language authorizing such purchases in all future bank trust instruments.

Finally, S. 1609 generally would prohibit banks, whether acting as principal or fiduciary, from knowingly purchasing, during a securities distribution, any security of which the bank's securities affiliate is the principal underwriter. This is an area that should be covered by any legislation expanding the underwriting activities of bank securities affiliates.

2. Anti-tying prohibitions

As the Committee is aware, Section 23A does not deal specifically with tie-ins. The anti-tying provisions in Section 106(b) of the Bank Holding Company Act (12 U.S.C. 1972) have some application to this area. It is not clear, however, that Section 106(b) is sufficient to guard against tying abuses with respect to securities subsidiaries or affiliates.

A potential problem, if banks are allowed to have securities subsidiaries (as opposed to affiliates), is that Section 106(b) does not appear to prohibit a bank from conditioning a loan or other services upon a requirement that additional services be obtained from or provided to the bank's subsidiary. As currently written, Section 106(b) only prohibits banks from conditioning loans or other services upon a requirement that additional services be obtained from or provided to the bank, a bank holding company of the bank, or a subsidiary of the bank holding company. Thus, Section 106(b) would not appear to prohibit a bank that is not part of a holding company structure from conditioning a loan upon a requirement that the borrower use the bank's securities subsidiary as the underwriter for an offering of securities.

Moreover, Section 106(b) does not prohibit banks from tying loans to a customer's purchase of trust services, especially the management of pension funds. Such tying may not be in the best interests of the employees whose pensions are managed by their employers' banks. (See 12 U.S.C. 1972 (1)(A).) The employers may be impelled, albeit subconsciously, to subordinate the quality of management of their pension funds to the need to maintain a favorable credit relationship with the bank.

Finally, as recognized by the Treasury in its proposal of last year, S. 2490, Section 106(b) proscribes only conduct by banks. It does not prohibit bank securities subsidiaries or affiliates from conditioning their services upon a requirement that the client obtain additional services from, or provide them to, the bank.

For these reasons, we recommend that Congress consider amending Section 106(b) to correct the three problems just described. Tying arrangements are extremely difficult to police. Congress should consider whether additional resources will be necessary for agencies to effectively enforce the anti-tying provisions of Section 106(b) with respect to bank securities affiliates; or whether some other means of dealing with the problem should be adopted. The Treasury proposal would authorize actions by trade associations to enforce the provisions of Section 106(b).

QUESTION 2: "I ask you to submit your comments with respect to [your proposal to amend the Bank Holding Company Act to close the loophole that facilitates acquisitions of 'non-bank' banks, and the Glass-Steagall Act to change the term 'member bank' to 'any institution receiving deposits insured by an agency or corporation of the United States'] and the reasons you've outlined in a little further detail to this Committee."

ANSWER: Both the acquisitions of "non-bank" banks and the FDIC's recent proposal to allow federally-insured state-chartered nonmember banks to expand their securities activities have the potential to introduce major structural changes in the financial service industries. Once implemented, Congress may well find it difficult to undo these changes, even if it determines they are not in harmony with public policy. Instead of allowing changes in the industries to continue to occur on an ad hoc basis, Congress should review and re-evaluate public policy with respect to the structure and regulation of the financial service industries. During his June 8th testimony, Chairman Shad suggested amendments to the Bank Holding Company Act and the Glass-Steagall Act which would address these issues. These proposals are set forth below.

1. "Non-Bank" Banks

The "non-bank" bank trend is a fairly recent occurrence. Because of the narrowness of the definition of the term "bank" in the Bank Holding Company Act ("BHCA"), corporations that engage in activities not permissible to bank holding companies have recently been able to acquire entities which are "banks" in the ordinary sense of that term without becoming subject to the BHCA. These firms include Dreyfus Corporation and J. & W. Seligman & Co., both of which are engaged in securities activities under the Commission's regulatory jurisdiction.

Section 2(c) of the Act, 12 U.S.C. 1841(c), defines "bank" as "any institution * * * which (1) accepts deposits that the depositor has a legal right to withdraw on demand and (2) engages in the business of making commercial loans * * *" (emphasis supplied). Thus, a depository or trust institution that does not both accept demand deposits and make commercial loans does not appear to be a bank for the purposes of the Act. The consequence of this is that securities and other non-banking firms may acquire institutions chartered as banks without being subject to the restrictions of the Act, so long as it refrains from either commercial lending or the receipt of deposits. This legal peculiarity is crucial to an acquiring firm which is engaged in activities unrelated to banking since the BHCA prohibits bank holding companies (i.e., any entity which owns a "bank" as defined in the BHCA) from engaging in any non-banking business, unless that business is determined by the Federal Reserve Board, pursuant to Section 4(c)(8), 12 U.S.C. 1843(c), to be "so closely related to banking * * * as to be a proper incident thereto." Retailing consumer goods and underwriting corporate debt and equity securities -- activities in which certain contemporary financial conglomerates are engaged -- are not included in the list of closely related activities. 3/

In acquiring the Lincoln State Bank, Dreyfus indicated that it would divest the bank's commercial loan portfolio, thus removing Lincoln State from the definition of bank under

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3/ Activities permissible under the Bank Holding Company Act include: operating a mortgage, finance, credit card or factoring company; operating an industrial loan company as authorized by state law; servicing loans and other extensions of credit; engaging in trust company activities; providing limited investment or financial advice; leasing or acting as an agent, broker or adviser in the leasing of personal property; making equity and debt investments in community welfare projects; providing bookkeeping or data processing services; providing courier services; providing management consulting services to nonaffiliated banks; selling money orders, traveler's checks and savings bonds; performing real estate appraisals; and acting as an investment adviser to an investment company registered under the Investment Company Act of 1940. 12 CFR 225.4; 225.125.

the BHCA and insulating Dreyfus from the applicability of the BHCA. The FDIC, which considered the application, did not disapprove the acquisition.

Similarly, both Dreyfus and J. & W. Seligman applied to the Comptroller of the Currency for national bank charters. In both instances, the applicants indicated that the new bank would not, at least initially, accept demand deposits or make commercial loans. The Comptroller approved both applications. In the Dreyfus matter, the Comptroller expressly concluded that the newly-chartered national bank will not be a bank for purposes of the BHCA; in the case of Seligman, the Comptroller did not even comment on the issue. These decisions engendered a controversy between the Comptroller and the Federal Reserve Board, the Board taking the position that the Act is applicable and threatening to fine the banks when they apply to purchase Federal Reserve stock, as is required of all national banks.

The Board's position is predicated on its view that, for BHCA purposes, commercial lending includes the purchase of commercial paper, bankers acceptances, and certificate of deposits, the extension of broker call loans, and similar lending activity. The Board concluded that since Dreyfus National Bank would accept demand deposits and use those deposits to purchase commercial paper, CDs, and similar instruments, the bank would be engaged in commercial lending. Accordingly, in the Board's view, Dreyfus National will be a bank for BHCA purposes, and thus, Dreyfus will be a banking holding company. In response to the controversy, the Comptroller imposed a temporary administrative moratorium on granting such charters.

It would be relatively simple to call a halt to such non-bank acquisitions by striking the second part of Section 2(c) of the Act so that it would apply to "any institution * * * which accepts [demand] deposits." Another solution would be to put the two clauses in the disjunctive by changing the "and" to "or." This, however, would have the effect of subjecting all firms that make commercial loans -- many of which are not "banks" in the conventional sense -- to the Bank Holding Company Act. Either solution could be adopted as a permanent amendment to the BHCA or they could be coupled with an automatic repeal of the amended language after a fixed period, or some other technique to limit the time during which the amendment would be effective, if Congress determines that it needs an opportunity to consider the issues in a deliberative and reasoned manner without removing the sense of urgency for immediate action.

Another alternative is contained in the Treasury proposal recently introduced as H.R. 3537 and S. 1609. The proposal would remedy the non-bank bank situation by amending the definition of "bank" as defined in the BHCA to include any insured bank as that term is defined in the Federal Deposit

Insurance Act or any institution eligible to become such an insured bank. We understand that all the non-bank banks presently in existence are insured or are eligible for insurance and would be subject to the BHCA, if the amendment, as contained in the Treasury's proposal was adopted. Although this amendment would prohibit the acquisition of non-bank banks by full-service brokerage firms and retailing firms as well as other firms engaged in non-bank activities that are not permissible activities for bank holding companies, current non-bank banks could continue under the proposal subject to a grandfather clause, if they were acquired prior to July 1, 1983. Nonetheless, the grandfather rights would terminate if the bank attempted to engage in activities not permitted prior to that date or if the Federal Reserve Board determines that termination is in the public interest. This solution as proposed is not a temporary remedy but rather a comprehensive long-term solution to the problem of non-bank banks.

The Federal Reserve Board recently proposed a legislative moratorium, which was introduced as S. 1532 by Chairman Garn, and as H.R. 3413 by Congressman Schumer. Both the House and Senate versions would prohibit the acquisition of banks or S&Ls by any company that engages in activities not permissible to bank or S&L holding companies. An interesting aspect of the proposed legislation is that it would apply not only to federally-insured state banks and S&Ls but also to any bank or S&L eligible for federal insurance, which presumably would include most state banks. Chairman St Germain has also introduced a broader moratorium proposal as H.R. 3499.

In general, if moratoriums do not have definite expiration dates, they do not impose adequate pressure to act. S. 1532, the Senate version of the Board's proposal, has an expiration date of six months from enactment, while H.R. 3413, the House version, introduced by Congressman Schumer, would not expire until the end of 1984. The shorter period would be preferable in order to encourage prompt Congressional consideration of these issues.

2. Scope of the Glass-Steagall Act

In May of this year, the FDIC proposed a regulation that would allow federally-insured non-member banks to organize securities subsidiaries. Section 20 of the Glass-Steagall Act, 12 U.S.C. 377, which read literally applies only to Federal Reserve member banks, prohibits such banks from being affiliated with entities which "engage principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail through syndicate participation of stocks, bonds, debentures, notes, or other securities." 4/

4/ Section 16 of the Act, in effect, prohibits banks from engaging in those activities directly, but excludes U.S. government obligations and general obligation state and municipal securities from this prohibition.

The FDIC interprets this section as imposing no restraints on the affiliation of federally-insured, non-Fed-member, banks with securities firms engaged in underwriting. 5/ The validity of the FDIC's position is currently in litigation. Nonetheless, this proposal paves the way for non-member banks to engage, for the first time, in a broad range of securities activities. Such a step is properly a matter for Congressional determination.

This issue could be addressed immediately by amending Section 20 to replace the term "member bank" with the phrase "any insured bank as that term is defined in Section 1813(h) of this title." 6/ The consequence of this amendment would

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5/ Section 20, as originally adopted, also applied to federally-insured state banks since they were required at the time to become members of the Federal Reserve System in order to be federally-insured. In 1939, this provision of the Federal Reserve Act was amended, giving insured state banks the option not to join the system. S. Rep. No. 91, 95th Cong., 2d Sess. 200 (1977).

Section 21 completely prohibits banks and securities firms engaging in both securities and banking activities except to the extent permitted by Section 16. Arguably, the activities that would be authorized by the FDIC proposal would not violate Section 21 since a bona fide subsidiary is performing them and not the bank directly. See Board of Governors v. Investment Company Institute, 450 U.S. 46 (1981), in which the Court concluded that the prohibition in Section 21 that bars a bank from engaging in certain activities does not necessarily bar an affiliate from engaging in the same activities.

6/ 12 U.S.C. 1813(h) defines "insured bank" as "any bank the deposits of which are insured in accordance with the [Federal Deposit Insurance Act]."

be to apply the anti-affiliation provision to federally-insured non-Fed-member state banks as well as to Fed-member banks. As with the non-bank bank issue, a major change such as that proposed by the FDIC merits careful consideration by Congress. An amendment to prevent the FDIC from adopting its proposal could be adopted as a permanent revision to the BHCA, or, if coupled with an automatic repeal after a defined period or other time-limiting provision, it could be adopted as a temporary solution to give Congress the opportunity to address the issue.

S. 1532 and H.R. 3413 also address this issue. Section 5 of each bill would impose a limitation on non-banking activities of state-chartered depository institutions. The proposal would apply, not only to federally-insured state banks, but also to any bank or S&L eligible for insurance, thereby limiting the activities of most state banks. The bill would prohibit a state-chartered depository institution from engaging in any activity not previously engaged in unless it is:

(1) permitted by the Bank Holding Company Act;

(2) expressly authorized by state statute or interpretation before Jan. 1, 1983; or

(3) expressly authorized by state law, performed exclusively in the authorizing state, and provided only to customers physically located in the state.

As with the non-bank bank issue, the Fed's proposal essentially would accomplish the same goals. The primary distinction between the proposal to amend Section 20 set forth above and the Board's proposal is the grandfather clause for activities previously authorized by the states. However, the proposal to amend the section could be altered to incorporate a grandfather provision.

An alternative solution is found in the Treasury proposal, recently introduced as H.R. 1609 and H.R. 3537. This proposal, discussed above in connection with the non-bank bank issue, would prevent state-chartered federally-insured banks from engaging in underwriting corporate securities as the FDIC's rule would permit, by changing the definition of bank in the BHCA to mean any insured bank, as that term is defined in the Federal Deposit Insurance Act, or any institution eligible to become such an insured bank, or any institution that both accepts deposits that may be withdrawn on demand and makes commercial loans. If adopted, this amendment would apply directly to federally-insured non-member state banks or state banks eligible for federal insurance permitting them to carry out a limited range of securities activities through a parent holding company subsidiary. The securities activities permissible under the Treasury's proposal are underwriting and dealing in municipal revenue bonds and sponsoring, advising, and distributing mutual funds.

Conclusion

The amendments proposed to the Bank Holding Company Act and to the Glass-Steagall Act during Chairman Shad's June 8 appearance before the Committee should be considered in the context of a broad review by Congress of the financial service industries. The significance of these initiatives call for Congressional consideration, instead of agency action on an *ad hoc* basis. Congress should undertake a review of the regulatory structure in order to simplify it and rationalize it along functional lines. The amendments discussed above could provide Congress with a statutory means to halt the present virtually uncontrolled changes in two major areas, while it considers rational, coherent solutions to current problems.

Prepared by: Alan Rosenblat
Gerald Laporte
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AR-75-GL/LS-ow/sl/pf

EROSION OF GLASS-STEAGALL

Senator D'AMATO. OK. On page 1 of your testimony you recommended that we amend our regulatory scheme in order to promote fair competition and assure proper protection to depositors and investors. On page 4 of your testimony you list examples of the erosion of Glass-Steagall in which you suggest that many of the recent mergers go beyond a combination of commercial banking and investment banking, that you find permissible.

In the name of fair competition and safety and soundness, do you recommend that we dismantle these particular financial conglomerates or would you recommend a moratorium on future mergers?

Mr. SHAD. I would be very reluctant to recommend the dismantling of a company like Sears Roebuck which is engaged most pervasively across the board on a large-scale basis, and moratoriums have the disadvantage of stopping something and giving less urgency for congressional action. But I see this thing as a situation where we have holes in the dike, if you will, and the water is pouring through at an increasing rate; if the dikes are desirable, I think it does require prompt remedial action. I'm not sure whether this would be more difficult than a moratorium from a legislative point of view, but it's notable that two of the serious questions that are being tabled today—one of them we haven't discussed as yet, but it's the "nonbank bank" trend and the other is the FDIC corporate underwriting and a whole host of other activities—arise through what some have characterized as loopholes in the present laws.

It's amazing to me that by one word change in the Bank Holding Company Act you could deal with the nonbank bank problem; change the word "and" to "or," since the reason that this opportunity exists for nonbanking companies to acquire banks is because a bank is defined as an institution which takes deposits and makes commercial loans. If it said "or makes commercial loans," because they get rid of one or the other using the commercial lending side, that would take care of that issue. I know Senator Garn has mentioned on past occasions the need for equality. If you're going to restrict one side, you should be restricting the other. So that would restrict the securities firms from going into the banking business through nonbank banks.

Senator D'AMATO. Are you suggesting that we undertake that?

Mr. SHAD. I think it's a way to immediately deal with an emerging problem—to give Congress the time to stop mergers, as a moratorium would, but to give Congress the time to come up with appropriate alternatives.

And I would like to see, if you will permit me, a package which also would include a change in the Glass-Steagall Act—and it's a minor change—to change "member bank" to "any federally insured depository institution," which would foreclose the FDIC's approach instantly. And with that, as long as we're amending Glass-Steagall, I would certainly again strongly endorse the separate corporate affiliates approach because I believe that that cures a whole host of these problems. It's not a panacea, but it does go a long way. Once you get competitive activities subject to the same rules and regulations and tax treatment, you've really addressed an enormous portion of the inequality and unfair competition.

Senator D'AMATO. John, I ask you to submit your comments with respect to this including the reasons you've already outlined in a little further detail to this committee. I would deeply appreciate it. I think this is an important matter that requires greater examination. There might be a manner in which we could address some of the legitimate concerns without tearing down all the walls and watching the floodwaters come on over.

Thank you very much, Mr. Chairman.

The CHAIRMAN. I wish you hadn't mentioned floodwaters with what is going on in my home State.

Senator HECHT. You don't have a monopoly on that, either.

The CHAIRMAN. Well, Senator Hecht represents the most arid State in the country; I represent the second most arid State, and we have been trained to represent deserts. We are not trained to represent—I've been fighting my whole career for reservoirs to store water and keep it through the summer, and now it's running all over our States. We still need the reservoirs to store it when the droughts come back, which they will.

Mr. SHAD. In referring to the $380 billion of money that's moved into the money market funds as a result of the bill that you sponsored, I resisted the temptation to refer to the cascading flows of capital that you triggered.

The CHAIRMAN. I appreciate that very much.

Thank you, Chairman Shad. We appreciate your willingness to be here today.

Mr. SHAD. Thank you very much.

The CHAIRMAN. Next we have the Honorable William F. Baxter, Assistant Attorney General, Antitrust Division, Department of Justice.

STATEMENT OF WILLIAM F. BAXTER, ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION, DEPARTMENT OF JUSTICE

The CHAIRMAN. Mr. Baxter, we are happy to have you before the committee today.

Mr. BAXTER. Thank you very much, Senator. I welcome this opportunity to present the views of the Department of Justice.

I do wish to stress that I am speaking for the Department of Justice; the administration has not as yet worked out a final position on some of these matters. As you know, the Vice President is chairing the task group on problems of financial service regulation, on which the Attorney General also sits.

Due in major part to the important work of this committee in the last Congress, the Garn-St Germain Depository Institutions Act of 1982 dealt in a very positive way with a number of the troublesome issues that affect the status of competition in these areas.

As the chairman's letter inviting us to testify indicated, there are other issues that remain, and in our view, at least, further reforms are necessary in order to take maximum advantage of the efficiency that would derive from more intensive competition in a variety of areas.

MAJOR AREAS OF REFORM

I would like to suggest three major areas of reform today which are not addressed in the Garn-St Germain Act and which, in our view, warrant the attention of the Congress.

The first of these is the elimination of geographic restrictions, those that derive in particular from the McFadden Act and from the Douglas amendment to the Bank Holding Company Act.

The second is restrictions on product market expansion, dealing primarily with the Glass-Steagall Act.

Finally, I would like to see the elimination of the highly redundant and excessive review process that now applies uniquely to bank and bank holding company mergers and acquisitions.

Of course, quite distinct from this set of concerns is the size and shape of the regulatory system itself. As I say, that is being addressed by the Vice President's task force.

As you all know well, the McFadden Act prohibits State branching and permits each State to determine its permissible extent of branching, both of national as well as State banks within the individual States.

The Douglas amendment prohibits a bank holding company from acquiring a bank in another State unless specifically authorized by legislation of that State.

Savings and loan associations or thrifts were granted important new powers by the Garn-St Germain Act, while this permitted them to diversify their activities, at the very same time, that act codified what had theretofore been only Federal Home Loan Bank Board imposed limits on geographic expansion by those thrifts that exercized their Garn-St Germain powers. We were disappointed by that action and hope that it, too, would be reconsidered in conjunction with a general loosening of geographic restrictions.

While the McFadden Act prevents banks from operating openly full-service offices in other States, it doesn't really prevent interstate competition totally. Bank holding companies are permitted to provide a wide variety of banking and financially related services in other States, such as loan production offices, affiliated trust companies, mortgage banking, and consumer and business lending activities. Other options for interstate expansion are possible, but the shape the competition takes is determined by the idiosyncratic phrases of Federal statutes rather than by any open competitive process. Moreover, the current statutory scheme is more costly, less efficient, and necessitates a broadening in the spread between the bank's cost of money and the interest rate at which it is able to make loans.

CREATIVE OPTIONS FOR INTERSTATE BANKING ACTIVITIES

There are still other more creative options for interstate banking activities of a kind, such as the so-called nonbank bank problem that has arisen recently with respect to holding companies or institutions that do not engage in commercial lending. Those are still in somewhat more doubt.

Obviously, if that possibility is available, a bank holding company could operate a so-called consumer bank; down the street it could open up a loan production office, and in conjunction it would be affording something closely approximating full banking services, but again in a distorted and certainly a somewhat inefficient manner.

Particularly important, in my view, is the interstate status of electronic funds transfer systems. As the committee knows, an EFT terminal has been held by the courts, in rather peculiar opinions in my view, to be a branch bank within the meaning of the McFadden Act. The situation of EFT terminals with respect to the thrifts is quite different and this creates a peculiar and unhappy distortion between the ability of the banks and the thrifts to deploy EFT terminals, also known as automatic teller machines or [ATM's].

Furthermore, in a number of States the State law does not consider an ATM to be a branch, with the consequence that State banks may be able to deploy them on an interstate basis. The McFadden Act nevertheless treats ATM's as branches, thus placing national banks at a competitive disadvantage with State-chartered institutions.

The primary arguments which have been advanced to justify this welter of anticompetitive provisions are strangely enough that there would be an increase in concentration if they were removed, and it would result in the demise of many small banks.

Neither of these arguments seems to me to have any validity.

The studies of economies of scale in banking indicate that, as to most local functions, economies of scale disappear at relatively small size. Thus, there is no reason to expect that small banks will be unable to achieve efficient operating levels and unable to provide competitive services. Indeed, in States such as my own State of California, that have long permitted statewide branching, we see very large institutions and very small institutions competing effectively side by side, and there is no particular reason to think that small banks as opposed to local monopolies would disappear.

Indeed, the introduction of additional competition would surely intensify competition and reduce concentration measured in any sensible way.

If it is not possible at this time totally to repeal these geographic restrictions, lesser steps seem to me to be appropriate and are urgently needed. One would be to permit statewide branching by national banks, so as to achieve comparability between federally chartered savings and loan associations and national banks, and the second would be an amendment to exempt EFT systems from the coverage of the McFadden Act so their deployment could be broader.

The deployment of EFT systems in particular has the potential of introducing much needed competition into a variety of sheltered markets.

Turning to restrictions on the product that banks can offer, these of course are found primarily in the Glass-Steagall Act. Here, too, changing technologies have resulted in a substantial degree of diversification, notwithstanding the provisions of the act. But nevertheless, again, the scope of the available product is limited, and in some sense is distorted, by the provisions of the act.

Very shortly after the Glass-Steagall Act was passed, the Congress, in the Securities Acts of 1933 and 1934, enacted some of the provisions governing underwriting and dealing in corporate securities, full disclosure, limitations on insider trading, and self-dealing. In addition, since that time Congress and the Federal regulators have subjected commercial banks to ever more extensive regulation of the kind intended to protect consumers. The combination of these measures seems to me to have lessened substantially the potential for abuses in both commercial banking and in securities markets which led to the passage of the Glass-Steagall Act.

Again, it seems to me the time has come to consider eliminating those prohibitions.

LIMIT OF FREEDOM TO DIVERSIFY

The Bank Holding Company Act also limits the freedom of banking organizations to diversify into new product markets. The general prohibition, of course, appears in section 4(a), whereas 4(c)(8) permits bank holding companies and their subsidiaries to engage in additional activities, provided that the Board has determined that they are so closely related to banking as to be appropriately incident thereto. The Board, over the years, has determined that a number of activities are permissible and that other activities are not. But the need for the present statutory requirement seems to me very dubious. I see no reason whatsoever why diversification into a wide set of financial activities should not be permitted, subject only to the restriction that it not lead to unsafe banking practices.

Obviously, there is a problem with other activities imposing costs upon or shifting risks to the banking activity. But that can be addressed in a far more limited way than do the present statutory structures.

The statutory test at the present time requires the Board to balance public benefits against possible adverse effects. And here, too, the provision should be replaced in my view with one simply authorizing the Board to protect against the possible emergence of unsound banking practices. I see no valid reason for the Board to attempt to second-guess the marketplace with administrative judgments about what the public needs.

The true test of that will appear by the success or failure of the product in the market.

Finally, I would like to point out the very duplicative and wasteful competitive review process that presently applies to bank and bank holding company consolidations. Mergers and acquisitions by those institutions must receive advance approval from one or another of the three major bank regulatory agencies. They apply the Bank Merger Act of 1966, and the Bank Holding Company Act of 1956, which, in turn, incorporates the standards of the antitrust laws, in particular section 7 of the Clayton Act.

Then, after the regulatory agencies get through applying that standard, the Antitrust Division essentially is required to do the same thing. Despite the fact that these agencies are supposed to be applying a uniform competitive standard that appears in the statutes, in fact that is not the case. The standards applied among the different agencies continue to differ in significant respects and to differ as well from the standard employed by the Justice Department. This situation is perhaps not surprising, since those agencies have expertise in financial areas, but there is no particular reason to expect those agencies to have any expertise in the application of competitive standards. All of this leads to a great deal of confusion and additional costs, and there seems to be very little reason for continuation of this situation. Such transactions, in our view, should continue to be reviewed for financial soundness, whether they are consistent with good banking practices, but the competitive review should be a single process, analogous to those applicable to the thrift industry, which, unlike banking, is subject directly to section 7 of the Clayton Act and to the prenotification requirements of the Hart-Scott-Rodino Act. That would certainly greatly simplify the situation in banking.

Of particular concern is the fact that the broad scope of the Bank Merger Act and the Bank Holding Company Act catch all sorts of transactions, phantom mergers, formation and acquisition of de novo banks, and corporate reorganizations, that pose no possibility whatsoever of anticompetitive problems and yet all are subject to the unjustifiable regulatory delays that are in the present statutory structure.

As you know, after review, all of these transactions are held up for a period of 30 days, which is intended to create a window for us to go in and file an antitrust case, if we wish to do so.

But the statutory structure doesn't give us or anyone else any method for saying before the expiration of that period that the proposed transaction it is OK, there are no competitive problems, go ahead, thus, the present statutory scheme results in totally unnecessary delays in the vast majority of transactions.

Last year, the Department reviewed over 1,800 depository institution merger applications. The great preponderance of these were within these categories of phantom mergers, formation and acquisition of banks, or reorganizations. In fact, we submitted only about a dozen reports concluding that proposed transactions involved significant adverse effects on competition. Thus, a great deal of wasted motion and unnecessary delay is entailed by the present system.

That concludes the remarks that I wish to make this morning, Mr. Chairman. I am grateful for the opportunity to talk with you, and will do my best to answer any questions the committee may have.

[The complete statement follows:]

U.S. Department of Justice

Washington, D.C. 20530

TESTIMONY

OF

WILLIAM F. BAXTER
ASSISTANT ATTORNEY GENERAL
ANTITRUST DIVISION

BEFORE THE

COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

CONCERNING
COMPETITION IN THE FINANCIAL
SERVICES INDUSTRY
JUNE 8, 1983

Mr. Chairman and Members of the Committee:

I welcome this opportunity to present the views of the Department of Justice on the condition and structure of the domestic financial services industry and the state of competition among its increasing roster of players. I should note that these views are only those of the Department of Justice. The Administration has not yet adopted its final position. Some of these issues are presently being addressed by the Vice President's Task Group on Financial Services Regulation, of which the Attorney General is a member.

Due largely to the extremely important work of this Committee in the last Congress, the Garn-St Germain Depository Institutions Act of 1982 dealt positively with several issues affecting the health and competitive vigor of the nation's depository institutions. However, as the Chairman's letter inviting the Department to testify at this hearing recognized, that Act did not address certain other issues. Thus, while reform of the financial services industry has begun, further reforms are, in our view, necessary in order to maximize reliance on competitive opportunities in this industry. We recognize today that regulation cannot effectively divert nor contain free market forces and, except in very limited circumstances, it is inappropriate for regulation to be used in this manner. Thus, reform should continue to focus on elimination or reduction of unnecessary and costly regulations.

In the last several years, the Department of Justice has been advocating changes in the current statutory and regulatory environment governing our financial services industry. These changes, in our view, would eliminate unnecessary barriers to the effective functioning of free market forces and the working of the competitive process, and, thus, would permit greater economic efficiency in this vital area of the nation's economy. As part of this effort, the Department has both testified before and submitted written statements to the Congress, including this Committee, filed numerous sets of comments with regulatory agencies, participated in Executive Branch deliberations, and made public statements calling for competitive reform.

Today I suggest three major areas for reform which were not addressed in the Garn-St Germain Act and which warrant prompt attention by the Congress. These are: (1) the elimination of geographic restrictions on the activities of banks and bank holding companies, particularly the restrictions contained in the McFadden Act and the Douglas Amendment to the Bank Holding Company Act; (2) the elimination of the statutory provisions limiting product market expansion by various types of financial institutions, particularly the Glass-Steagall Act; and (3) the elimination of the redundant competitive review process uniquely imposed by statute on banks and bank holding companies wishing to merge. Of course, separate and apart from these legislative changes is the need to address reform of the financial regulatory system as the Vice President's Task Force is currently doing.

Geographic Restrictions on Bank Expansion

The principal statutory restrictions on geographic activities of banks are contained in the McFadden Act and the Douglas Amendment. The McFadden Act prohibits interstate branching and permits each state to determine the branching structure of national as well as state banks within its borders. The Douglas Amendment prohibits bank holding companies from acquiring a bank in another state, unless the state in which the bank to be acquired has affirmatively provided for such out-of-state entry.

Moreover, although the Garn-St Germain Act granted new powers to savings and loan associations, permitting thrifts to diversify their activities, it also codified Federal Home Loan Bank Board-imposed limits on geographic expansion by savings and loan associations that exercise these new powers. Thus, to some extent, geographic prohibitions received a temporary breath of fresh regulatory life. We would hope that the resuscitation is short-lived.

While the McFadden Act and the Douglas Amendment have generally prevented banks from operating full service offices outside their home state, they have not totally prevented banks and bank holding companies from providing a wide variety of banking or related financial services on an interstate basis. For example, many banks operate loan production offices outside their home state. In addition, banking organizations have established trust company affiliates outside their home state. Also bank holding companies are permitted to engage in such activities as mortgage banking and consumer and business finance on an interstate basis.

Other options for interstate expansion may exist which can be used by creative banking organizations. For example, both the Federal Reserve Board and the Comptroller of the Currency have determined that a bank which does not engage in commercial lending operations is not a "bank" within the meaning of the Bank Holding Company Act. Theoretically, a bank holding company could acquire a "consumer" bank in a state or several states other than the one in which it operates its "full service bank." In addition, the full service bank could operate loan production offices in the same areas in which its "consumer bank" affiliates operate, thus giving the holding company a substantial interstate presence for all banking activities.

The existing statutory restrictions, therefore, limit rather than prohibit interstate competition by banking organizations and they channel such competition into forms dictated by legal interpretations of such words as "bank" rather than into economically efficient forms of doing business.

Moreover, the interstate status of electronic funds transfer ("EFT") terminals under existing law differs depending on whether the terminal is installed by a bank or a thrift. Thus, an automated teller machine ("ATM") installed by a bank is a "branch" and therefore subject to the McFadden Act's limitations while the same machinery can be deployed on an interstate basis by a thrift. The result created by the McFadden Act in this area becomes all the more apparent where there are differences between national and state banks in their freedom to deploy ATMs. Thus, state law may not consider an ATM a branch but the McFadden Act treats ATMs as branches, thus placing national banks at a competitive disadvantage with state-chartered institutions.

The primary arguments which have been advanced against interstate banking are that it would lead to the demise of small banks and would result in increased concentration. Neither of these related arguments appears valid. For most banking services, there is little evidence of substantial economies of scale. Thus, smaller banks should be able to achieve efficient operating levels and continue to provide competitive services to a wide range of customers. Indeed, in those states which have permitted statewide branching, such as California, smaller banks have been able to compete successfully with much larger statewide organizations. Moreover, smaller independent banks frequently are able to adapt more rapidly to the specific needs of the markets they serve than are larger institutions headquartered in distant locations. Where new technologies may involve significant economies of scale, voluntary sharing arrangements would appear to provide a viable option for small banks.

In addition, increasing the potential for new entry into presently concentrated markets should improve the competitive performance of existing firms. When existing banks face competitive entry conditions, they often charge lower interest rates, pay higher rates on deposits, lower their fees and service charges, and generally improve their performance. In my view, the important benefits to be gained from the potential for increased competition if geographic restrictions are eliminated appear clearly to outweigh any dangers of increased concentration. Furthermore, the prevention of undesirable levels of concentration can and should be addressed through the antitrust laws, not through blanket prohibitions on interstate banking.

The Congress, in the Garn-St Germain Act, and the bank regulators have permitted some interstate expansion through the acquisition of failing institutions. The states have also taken steps to break down interstate barriers. Some states like Delaware and South Dakota have permitted out-of-state entry for limited purposes, *e.g.*, establishment in Delaware of a single office *de novo* bank. Some - Illinois, Iowa and Florida - provide for additional acquisitions by grandfathered out-of-state bank holding companies. At least three states - Maine, Massachusetts and New York - have enacted reciprocal statutes for acquisitions by out-of-state holding companies. Finally, Alaska permits out-of-state acquirers to enter without restriction. This momentum ultimately may lower barriers throughout the nation. However, the speed of these changes is uncertain and, in the interim, the continued costs of the existing barriers are too high a price for the industry and the economy to pay.

We believe that the time has come for repeal of the McFadden Act and the Douglas Amendment to permit depository institutions to expand where competitive opportunities appear. There simply is no valid reason for continuing the present unsatisfactory situation or for prohibiting efficient interstate competition in the financial services industry. At the very least, if total repeal is not yet to occur, two smaller steps are clearly necessary at this time. First, statewide branching by national banks should be permitted in order to give national banks the same branching authority which federally chartered savings and loan associations, including those which exercise their new powers granted under the Garn-St Germain Act, already have in their own states. This step would ensure the equality of expansion opportunities geographically.

Second, the McFadden Act should be amended to exempt EFT systems from its coverage. An amendment to the McFadden Act would permit the deployment of terminals according to the business judgments of financial institutions and the demands of the marketplace. The introduction of EFT competition into concentrated banking markets will result in greater availability and diversity of banking services and more competitive prices. In addition, greater freedom to deploy EFT terminals should reduce the possibility of monopolistic development of EFT systems since there would be less need for local network monopolies and more opportunity to achieve scale economies through competing regional or national networks.

Restrictions on Product Expansion by Financial Institutions

The principal restrictions on product expansion by financial institutions are contained in the Glass-Steagall Act, although the Bank Holding Company Act also limits the activities in which banking organizations can engage. We believe that the time has come for serious reconsideration of the continued effects of, and necessity for, these restrictions. As in the case of geographic restrictions, the limitations on product expansion are increasingly obsolete and are creating ways of conducting business operations which exist because of statutory interpretations rather than economic efficiencies.

The Glass-Steagall Act generally mandates the separation of commercial and investment banking. Various provisions of the Act prohibit national banks and state banks which are members of the Federal Reserve System from dealing in stocks and other securities and from issuing, underwriting, selling, or distributing stocks or other securities. In addition, firms that issue, underwrite, sell, or distribute securities are prohibited from engaging in the business of receiving deposits. Banks, however, are permitted to engage in certain specified securities activities, including the purchase and sale of securities as an agent for the account of a customer and the underwriting of United States Government obligations and state and municipal government general obligations.

Economic and technological developments in recent years have caused both banks and securities firms to offer financial services that may not fall clearly within traditional definitions of either commercial or investment banking. Examples of such relatively new activities include the development by securities firms of money market mutual funds and cash management accounts and the provision by banks of automatic investment services both to individuals and to corporate clients.

While the Glass-Steagall Act does not erect an absolute barrier to all competition between banks and securities firms and has no application to savings and loan associations, it does substantially limit the financial services each group can provide and interferes with the efficient functioning of the marketplace. The bank regulatory agencies have liberalized some of the restrictions on the securities activities of commercial banks. Nevertheless, agency action is slow, expensive, and ultimately limited by the agency's jurisdictional authority and the willingness of firms to test those limits. As a result, many banks are restrained from responding to market forces and achieving their full competitive potential.

At approximately the same time the Glass-Steagall Act was enacted, Congress also enacted wide-ranging provisions governing underwriting and dealing in corporate securities, including provisions concerning false and misleading information, insider trading and self-dealing, manipulation of securities markets, and the extension of credit for the purchase of securities. In addition, Congress and federal regulators have subjected commercial banks to ever more extensive regulation to protect bank customers. These safeguards have substantially lessened the potential for abuses in both commercial banking and securities markets that led to passage of the Glass-Steagall Act.

As I have noted, despite the general prohibitions of Glass-Steagall, there has been increasing competition between commercial banks and securities firms in recent years. These developments have demonstrated that increased competition from new entrants into various segments of financial services markets increases innovation and results in the offering of services at the lowest possible costs to consumers. Further opportunities for increased entry should result in even greater benefits. The Department of Justice thus believes it is time seriously to consider eliminating Glass-Steagall's prohibitions.

The Bank Holding Company Act also limits the freedom of banking organizations to expand into new product markets in response to competitive forces. While Section 4(a) of the Act is a general prohibition on non-banking activities, Section 4(c)(8) permits bank holding companies and their non-banking subsidiaries to engage in activities which the Federal Reserve Board has determined "to be so closely related to banking or managing or controlling banks as to be a proper incident thereto."

In enacting Section 4(c)(8), Congress intended to allow bank holding companies comparative freedom within the area of banking activities, but to prohibit them from engaging in commercial activities. Since 1971, the Board has determined that over twenty activities, including operating an industrial bank or industrial loan company, operating a discount brokerage firm, and performing real estate appraisals, are permissible activities for bank holding companies. The Board, on the hand, has determined that activities such as engaging in real estate brokerage and management consulting services are not closely related to banking. Moreover, it has determined in several instances that the operation of a savings and loan association by a bank holding company is not a proper incident to banking except when the thrift is failing.

The current limitations on bank holding company activities are both unfounded and burdensome. The bank holding company is a financial organization with a broader corporate mandate than its banking component. Given that the holding company is distinct from the banking subsidiary, the need to limit the holding company's activities is questionable. As with securities activities, the safety and soundness of an affiliated bank can be dealt with more efficiently by regulation aimed at specific problems rather than by perpetuating the present scheme. In sum, the holding company itself should be able to respond to the marketplace as freely and as efficiently as other broad-based financial service institutions.

I respectfully suggest two related proposals which Congress should consider to reform the Bank Holding Company Act. First, the test for acceptable activities should not depend on a close relationship to banking; instead it should allow bank holding companies to engage in all financially related activities subject to only the financial capacity of individual holding companies to undertake safely different types of financial activities. This approach would allow bank holding companies to engage in the full range of financial service activities, subject to appropriate statutory requirements that certain financial activities must be conducted through separate holding company affiliates, which would be regulated by other agencies.

Second, the statutory test requiring the Board to balance public benefits against possible adverse effects also should be replaced by a limited prohibition against activities that lead or amount to unsound banking practices. There is no valid reason for the Board to attempt to displace private business judgments with administrative determinations as to the public needs. The true test of the improvement of public welfare is the success of a new product, and reliance on market forces is the best way to ensure that services are offered at prices that consumers desire to pay. Moreover, any problem with decreased or unfair competition as the result of bank holding company activities can best be solved by reliance on the antitrust laws. Indeed, under the present structure these activities are fully subject to antitrust scrutiny. Thus, the only legitimate concern of the Board is the prevention of unsound banking practices and this test, strictly construed, should be the only restriction on bank holding company activities.

Modification of the Merger Review Process Under the Bank Merger Act and the Bank Holding Company Act

As the Committee knows, every bank merger or bank holding company acquisition involving a federally insured bank -- that is, most of the banks in the country -- must receive prior approval from one of the three federal bank regulatory agencies: the Comptroller of the Currency, the FDIC, or the Federal Reserve Board. Both the Bank Merger Act of 1966 and the Bank Holding Company Act of 1956 incorporate the standards of the antitrust laws, including Section 7 of the Clayton Act, which prohibits mergers or acquisitions that are likely substantially to reduce competition in any line of commerce in any section of the country. The regulators also must consider a number of other factors, including the financial and managerial resources and future prospects of the existing and proposed institutions, and the convenience and needs of the community to be served.

Despite the fact that the banking agencies are supposed to apply a uniform competitive standard, their approaches are frequently inconsistent. Indeed, the standards used by the agencies in considering the likely competitive implications of proposed transactions continue to differ from those employed by the Department as well as from the standards employed by each other. This situation is not surprising, since the banking agencies, while having expertise in the financial areas involved in a merger, have no special expertise in applying competitive standards.

Confusion is also evident from the regulators' use of the statutorily required competitive reports on the mergers they must approve from the other bank regulators and the Department of Justice. Again, the clear intent of the statute would appear to be to pool the combined expertise of the various agency participants and to achieve a consensus of views wherever possible. However, this statutory goal has largely been unfulfilled. As a recent report of the General Accounting Office concluded, the agencies frequently have disregarded recommendations submitted by coordinate agencies and by the Department and have often failed to disclose any reason for doing so in their opinions approving or denying particular mergers. 1/

This lack of uniformity among the agencies and the redundant competitive reviews imposed by the statutory scheme are costly in several ways. First, the lack of uniformity creates an uncertainty in the industry as to which mergers are to be permitted. Indeed, this lends to the phenomenon of forum shopping among regulators by applicants.

Second, the redundant reviews required by the existing statutory scheme add unnecessary costs to all transactions. The regulators must maintain duplicate staffs to perform these reviews, each with its own agency interpretation of what constitutes an anticompetitive transaction. Thus, transactions subject to the Acts are delayed while these reviews occur. Moreover, even where no regulator or the Department of Justice has found a competitive problem, the Acts mandate an additional 30-day waiting period after approval before consummation.

1/ Comptroller General, Bank Merger Process Should Be Modernized and Simplified 10-27 (August 16, 1982).

Finally, where the Department has filed suit to challenge a merger approved by a regulator, the district court is required to make de novo determinations of fact and law in reviewing challenged mergers. The regulator's competitive decision essentially is given no weight, and, in essence, a challenged bank merger ultimately is treated the same as a challenged merger in any unregulated industry. Thus, the present statutory scheme imposes barriers to all mergers that simply can no longer be justified.

It should also be noted that mergers between savings and loan associations -- including those that will increasingly resemble commercial banks as they exercise their new powers under the Garn-St Germain Act -- are subject to a somewhat different statutory and regulatory framework than are bank mergers. Savings and loan association mergers, while subject to Federal Home Loan Bank Board approval, are also subject to Hart-Scott-Rodino premerger notification requirements and to challenge under the antitrust laws, rather than the convoluted scheme established by the Bank Merger Act and Bank Holding Company Act. Thus, alternative schemes for competitive review of depository institution mergers already exist and others are possible.

Finally, the web of the Bank Merger Act and the Bank Holding Company Act catches transactions -- phantom mergers, formation and acquisition of de novo banks, and corporate reorganizations -- that present no possible anticompetitive problems, and subjects them to unjustifiable regulatory delays and significant filing costs. These costs, of course, deter efficiency-enhancing consolidations. In fiscal year 1982, the Department received and reviewed over 1800 depository institution merger applications, many of which involved, for example, the creation of so-called "phantom" banks used in connection with a holding company acquisition and corporate reorganizations, as well as real mergers. Despite the large number of applications reviewed, in fiscal year 1982 the Department submitted only about a dozen reports concluding that the transaction in question would be likely to have a significantly adverse effect on competition.

Although the application of bank merger review standards may be improved, the continued existence of multiple reviewing agencies precludes substantial uniformity in merger analysis. Moreover, multiple review of many transactions that pose no competitive questions unjustifiably increases transaction costs. Thus, the high costs and lack of benefits associated with the existing system fully justify adopting significant reform measures.

The Department of Justice believes that the Bank Merger Act and Bank Holding Company Act should be modified to remove the bank regulators from review of the competitive aspects of depository institution acquisitions and mergers. Instead, the competitive aspects of mergers and acquisitions involving depository institutions, like other financial firms, should be subject to the antitrust laws and the Hart-Scott-Rodino premerger notification procedure. This solution would expedite all mergers that pose no competitive problems, and would result in substantial savings in time and expense. Moreover, it would not interfere with the bank regulatory agencies' continued authority under the remaining statutory standards to take financial soundness and other appropriate considerations into account when reviewing proposed mergers.

We believe that this reform is especially appropriate at this time. Other financial institutions such as thrifts, securities and commodities firms, insurance companies, and finance companies currently are subject to the Hart-Scott-Rodino procedure and, where no competitive problems exist, can sometimes obtain early termination of that waiting period and avoid redundant competitive reviews. Moreover, this reform would rationalize competitive analysis for a broader range of participants the financial services industry, resulting in a more consistent approach to mergers in industry as a whole, as well as partial equilization of the transactional costs for merging institutions.

A possible transitional approach to eliminating the existing competition review function of the regulators is to begin with those states which permit unconstrained statewide branching.

In such states, there are fewer obstacles to an economically efficient, market-determined banking structure. Thus, in states with unrestricted branching, the Hart-Scott-Rodino review procedure could immediately replace the Bank Merger Act and Bank Holding Company Act process. This Committee, of course, could consider other transitional approaches as well. It is crucial, however, to recognize that the existing statutory and regulatory approach to bank mergers is no longer conducive to encouraging a dynamic and evolving competitive environment.

Mr. Chairman, the suggestions I have made today all are intended to reflect the significant changes which have occurred in the financial services markets and which will continue to occur in response to market forces and developing technology. It is imperative that our legal system also change to promote rather than interfere with the efficient functioning of this vital segment of our economy.

That concludes my prepared remarks. I would be happy to respond to any questions you or any other members of the Committee may have.

TIME HAS COME FOR REPEAL

The **Chairman**. Thank you, Mr. Baxter. You note on page 7 of your testimony that you believe the time has come for repeal of the McFadden Act and the Douglas amendment to permit depository institutions to expand where competitive opportunities appear.

This is a very strong statement that a lot of people would agree with: "There simply is no valid reason for continuing the present unsatisfactory situation of prohibiting interstate competition in the financial services industry."

However true that may be, I would not agree that there is no valid reason, because there is a valid political reason that McFadden will not be repealed. There are probably not more than 30 votes in the Senate, if that many, to do so. We simply have not had the Congress yet face the reality that interstate branching is occurring rapidly, the Glass-Steagall and McFadden Acts are breaking down in the marketplace, and they want to put blinders on and say it will go away if they don't think about it.

So your statement may be true from a substantive standpoint, but from a political standpoint there is a very valid reason why it will not be done.

I wish we could get Congress to come to grips with the realities of the marketplace and make decisions on these issues. I will certainly continue to push for them to do so.

Mr. **Baxter**. May I make an observation on that, Senator?

The **Chairman**. Certainly.

Mr. **Baxter**. There is an ironic feature—I agree with what you say. But there is an ironic feature to it. If we were to repeal Douglas and McFadden, there would be a very large number of substantial banking institutions that would become bidders for acquisition of many of these small local banks. Those local banks would be able to sell out at very handsome premiums, if indeed they felt unable to do well in light of the insuing competition. If the situation is gradually eroded by technology, as it has been in recent years, the value of those local institutions will gradually be eroded, and it is far from clear to me that from any self-interest standpoint these small institutions will really come out ahead in the end. I don't think the local bankers have really given that problem the consideration it deserves.

The **Chairman**. Obviously one of the most controversial topics before us right now is the issue of whether Congress should act to enact a moratorium. Chairman Shad discussed this a few minutes ago, whether we should simply have a moratorium, stop everything in place while we take a look at it. What is your feeling? Do you agree with the legislative moratorium?

Mr. **Baxter**. I am not sure exactly what would be subject to a moratorium in the proposal to which you refer.

In general, I think that moratoria are a bad idea. They almost invariably turn out to be a great deal longer than was contemplated initially, and our financial markets are subject to very rapid change, not a whimsical kind of change that is being ordained by willful individuals, but a change that is driven by changes in technology and the competitive process. Slowing down or completely halting change of that kind is a very costly process insofar as it preserves inefficiencies that could be eliminated by change, and it broadens the spread between the cost of money to the banks and the interest rate they are required to charge.

I believe the costs would be very substantial and I have not heard any justifications for a moratorium that I would regard as adequate.

The CHAIRMAN. What do you think of Chairman Shad's alternative that he just discussed? I don't know whether you were in the room then or not.

Mr. BAXTER. I was not in the room.

The CHAIRMAN. He was talking about changing the Bank Holding Company Act which now, as you well know, defines a bank as an institution which offers demand deposits and makes commercial loans. And there are two qualifications there. He suggested changing "and" to "or," a one-word change.

Mr. BAXTER. Yes, deposits or loans, as opposed to deposits and loans?

The CHAIRMAN. Right.

Mr. BAXTER. Of course that wouldn't be a monumental change. One would not be justified in predicting that we should start building an ark under those circumstances. Still, it is a change in the wrong direction in my view. Anything that slows down the gradual movement to a rationalized and competitive banking system, anything that serves the function of putting fingers in the dike to preserve an old inefficient and crumbling structure seems to me to be a mistake.

The CHAIRMAN. But in this case do you feel it was intentional originally? I mean it allows Dreyfus to buy one bank in New Jersey, which won't take demand deposits, and buy one in New York which won't have commercial loans, and therefore neither one is a bank, and yet together they are a bank.

Mr. BAXTER. Well, I am not sure exactly what the word "intentional" means in that context. Congress wrote the language it wrote, and I am sure it meant that an institution which accepted deposits and made loans was a bank. In that sense it was intentional.

On the other hand, I am not sure every Member of Congress foresaw the particular context of interpretation, the particular developments that resulted from it.

But in my view, the development is not unwanted, it is in the public interest, it introduces a new entry and additional competition into the markets involved, and I see no reason whatsoever for backtracking on that course.

The CHAIRMAN. I would doubt that any Member of Congress foresaw what would be going on in 1982 or 1983. If they had, I think a lot of things might have been written differently, or at least we would have taken action a lot sooner to try and keep up with the marketplace, which we have not done.

INADEQUACY OF ANTITRUST LAWS

Chairman Isaac stated in his testimony that current antitrust laws are inadequate because they focus on narrow geographic markets, while overall concentrations are not controlled, that there are rigid policies on small community bank mergers, while large financial conglomerates grow unencumbered.

Do you agree with Chairman Isaac's statement about the inadequacy of the antitrust laws?

Mr. BAXTER. No, I do not. In determining the geographic scope of banking markets, we look at the geographic area over which customers could practically turn to alternatives. The regulatory authorities have different approaches. They tend to focus actually on rather smaller areas in many cases and look only to where people are currently doing business rather than to the alternative sources to which they could turn. But recently some of them seem to have attempted to offset their use of excessively narrowly defined geographic markets by considerations of potential entry by banks that are not there at all, and often in our view substantially overestimate the likelihood that such potential entry will occur.

On the other hand, I am not sure what he means by concentration at some brand new level. It is true we have some very large institutions, but large institutions and concentration are not the same thing. The markets in which the large institutions compete are for the most part interstate, if not international, markets and in those markets there is not in fact a high level of concentration, notwithstanding that there are some very large institutions.

The CHAIRMAN. Senator Hecht.

Senator HECHT. In your testimony you constantly stress increased competition. Could you comment on how this increased competition will affect the safety and soundness of the industry?

Mr. BAXTER. Well, the safety and soundness of the industry will neither be aided nor threatened, in my view, by increased competition. The institutions are likely to be made more efficient, new technologies are likely to evolve more quickly. All of this will serve the purpose of narrowing the spread between money cost and interest rates.

But, of course, the soundness of the banking system has to be assured first and primarily by the self-interest of the owners of the individual institutions to protect against failure, and second, by the bank regulatory authorities in the nature of capital requirements and examination practices and so forth.

It has, I think, traditionally been the notion that if you somehow attenuate competition and let there be a little bit of monoply power, that somehow the institutions can earn more money and that this will contribute to their financial soundness. I think experience has indicated that that method of attempting to achieve soundness does not work very well, and it is very expensive for the consumers.

Senator HECHT. You mentioned that geographic restrictions should be lifted. Why not let the States decide this for themselves? Aren't they in a better position to determine what goes on inside their own borders?

Mr. BAXTER. I think sometimes they are. On the other hand, other times they are subject to even greater pressures than those that Chairman Garn described to maintain these pockets of monopoly in particular communities. At least as to national banks, it seems to me entirely appropriate for Congress to implement the competitive system that we have nominally supported in this area.

Senator HECHT. It is evident that the Department of Justice is concerned primarily with competition and how the consumer benefits. You tend not to focus on concerns of safety and soundness, which is the very foundation of our depository system.

What is your basis for suggesting that the banking system can sustain greater levels of risk, levels which they ultimately were unable to sustain prior to enactment of Glass-Steagall?

Mr. BAXTER. Of course so many things were different prior to the enactment of the Glass-Steagall Act that the comparison is a very difficult one to make.

It is perfectly true that the statutory responsibilities of the Department of Justice are focused primarily on competitive conditions and consumer welfare. We do not have direct responsibility for the soundness of the banking institutions.

Rather the problem of soundness has been given to the three major regulatory agencies, and the FDIC is a very important piece of this problem and its role is a significant one.

In every industry other than banking we are content, and for the most part very succcessfully so, to rely on the self-interest of owners to maintain soundness in say the steel industry or the grocery industry or the paper industry, and soundness is by and large maintained. There are, of course, failures and when failures occur, investors lose their stakes, and we say well, that is the nature of the game, there are of course risks and you have to take them.

The banking industry is different only because Congress, and quite rightly, I think, said that small depositors should not be viewed as investors who are putting their life savings at risk when they put them in a bank. There ought to be safe places for small depositors to put their money. And accordingly we ceated the FDIC. And that is a perfectly sensible thing to have done. But having done that, it seems to me that we never really accepted fully the implications of what we had done. Why does the presence of the FDIC take care of the only problem that there is? To the extent that there are big investors, whose deposits or claims against banks of one kind or another substantially are protected by the FDIC, why should those big investors be regarded any differently than investors in other areas of activity?

Senator HECHT. You just mentioned one point I want to ask you to comment on. I am trying to write it down, the words you said: "Small depositors are not investors."

Now Mr. Isaac sat in the same spot where you are and brought up perhaps the FDIC should not guarantee 100 percent of deposits anymore. Would you comment on that?

Mr. BAXTER. Well, I haven't thought about that particular possibility. My own inclination would be to continue to have the FDIC guarantee 100 percent of deposits up to some level. But I think the levels have gotten very high, and indeed are so high that they can no longer be said to be fulfilling the purposes that were initially conceived for them.

I think I am striving for the same objective that I would guess Mr. Isaac was striving for, and that is getting some risk back into the system, a greater degree of risk than there now is. But I would be inclined myself to continue to protect small depositors 100 percent and have no protection at all above relatively low threshold levels.

Senator Hecht. What would that threshold level be?

INSURANCE OF $100,000 PER ACCOUNT IS QUITE HIGH

Mr. Baxter. Again I haven't a set of proposals to make in this regard. My recollection, and it is only a recollection, I am not an expert on banking law, is that we are up to around $100,000 per account at the present time. That seems to me quite a high level. I think there must be very few people in this country, including some quite affluent people, whose bank deposits, as opposed to other forms of investment, exceed let me say $25,000, to simply pick a number.

My attempt would be to identify a level such as that that would protect most of our ordinary nonwealthy citizens and limit the protection to that level.

Senator Hecht. Thank you very much. No further questions.

The Chairman. Thank you, Senator Hecht.

Mr. Baxter, you talked a great deal about rationalizing the banking system. Do you feel that prior to 1929 we had a rational system?

Mr. Baxter. Yes, I think we had a rational banking system, but it was one that did impose significant levels of risk on depositors, just as if they were investors. I have no quarrel with the congressional judgment made in the 1930's that there ought to be a mechanism by which the ordinary citizen could do something with his money other than put it under the mattress, where he was not exposed to significant risk. And insofar as the banking laws of the 1930's aspired to that result, I think they are quite sensible.

The Chairman. On page 11 of your testimony you say the banking regulations which have been implemented by Congress and the Federal regulators provide enough safeguards to consider eliminating Glass-Steagall. Are you satisfied that there are currently on the books sufficient laws and regulations if Glass-Steagall were eliminated, as you recommend?

Mr. Baxter. I am not sure we should simply repeal Glass-Steagall outright. I think there are potential problems there. I have been talking for the last few minutes about a problem that the FDIC was addressed to and in some sense solved, but there is a different problem that it introduces. If banks or bank holding companies were able to diversify into just any activity and through just any corporate form of organization, one can imagine circumstances that would impose risks that have nothing to do with small depositors or the FDIC, because of the interdependency of different pieces of the Bank Holding Company Act, the possibilities of cross-subsidization, the possibilities that the cost of the failure would fall in some part on the FDIC.

I think we would have to think in terms of structural separations between the banking entity in a bank holding company and the other activities of the bank holding company, other than its financial activities, that would shelter the FDIC from those risks and would erect barriers against cross-subsidization. But having done that, I would be quite permissive about the range of financial activities that were permitted.

The CHAIRMAN. The Federal Deposit Insurance Corporation was obviously created to provide some stabililty in the system. It also envisioned that banks would not be involved in extremely risky or speculative activities.

So you are saying if Glass-Steagall were modified considerably, not totally repealed, there would still be a role for FDIC, but you would want to insulate some of those activities from the insurance and keep the FDIC pretty much as it is now?

LIMIT FDIC INSURANCE TO SMALL DEPOSITS

Mr. BAXTER. Yes. I would want to limit the FDIC's insurance to small deposits and I would attempt to substitute structural separations of the deposit-taking function from the other financial activities, so that the risks of these other financial activities were not ultimately imposed on the FDIC.

The CHAIRMAN. Are you satisfied, when you say small deposits with the current $100,000 Federal deposit insurance?

Mr. BAXTER. As I indicated a moment ago, that seems to me a rather high number.

The CHAIRMAN. Well, I certainly don't consider it a small deposit, but maybe some people do, maybe some of my colleagues think $100,000 is pocket money. I still consider it large, even after having been in the Senate for 9 years. I am still impressed with $100,000.

Mr. Baxter, I have no additional questions today. Thank you very much.

Mr. BAXTER. I thank you very much.

The CHAIRMAN. I'd like now to invite to the witness table the Honorable George Douglas, Commissioner of the Federal Trade Commission.

Mr. Douglas, before you begin, I would like to get somewhat off the subject of today's hearings.

As you're well aware, and many other people are, the FTC is culminating 8 years of a rulemaking proceeding on the proposed credit practices rule, and it's scheduled to be considered by the Commission this coming Monday.

I understand you just completed oral arguments in the past 2 days, and although it is somewhat off the subject, I want to take this opportunity with you being here to testify today to voice my opposition to the FTC's proposed credit practices rule and I would hope you would express my opposition to the other commissioners, for whatever that is worth or not worth.

But leaving aside any substantive arguments against the rule, you may or may not have been here earlier today or on several occasions when I expressed opposition procedurally to what the FDIC is attempting to do in State chartered institutions, feeling that that is a legislative decision, a major policy decision that should be made by Congress. And so I do very strongly believe the proposed credit practices rule reflects a very broad and bold usurpation of both State and Federal legislative authority. In fact, the sweeping nature of the proposed rule reflects a disregard for even the Commission's own standards which have been enunciated recently in order to establish a concrete framework for the exercise of its unfairness authority.

Opposition is based on the very strong belief that it is not the proper role of the FTC to substitute its judgment on public policy for elected members of State and Federal Government. Our governmental system's major public policy determinations such as those reflected in the proposed credit practices rule should be made by popularly elected State and Federal representatives and not by appointed Federal officials.

I want to make it clear I have some opposition to the rule itself, but even if I did not, even if I favored the rule, I would be making the same statement today on a procedural basis. It is too big a policy decision to be made by appointed officials, just as I feel about Chairman Isaac's recommendations at the FDIC.

It's been a consistent policy of mine and I understand that often Congress does not have the courage to make decisions. I've seen it in this committee where we have written laws and we come up with boilerplate language like at the Federal Reserve Board and said, "We give the Federal Reserve 180 days to come up with rules and regulations implementing this section of the act," and when the 180 days is over and they come up with rules we don't like, then we make public statements and issue press releases about that silly Federal Reserve Board and why they made that kind of decision.

So we cop out and when we complain about regulatory agencies usurping power it is almost always because we gave them that power, but this is one Senator who feels that elected public officials ought to face up to their responsibilities, and major policy decisions should be made by those of us who face the electorate and the consequences of our decisions.

So once again, even if this were a rulemaking procedure that I agree with the substance of I would oppose it as being far too broad-reaching for the Federal Trade Commission to make. So I strongly oppose it and, for whatever it's worth, I hope you would convey that to your fellow commissioners.

Mr. DOUGLAS. Senator, I'll be glad to convey your feelings to the Commission. I must say that I share some of your reservations regarding legislative activities of unelected officials. This topic was raised in my confirmation process, and I made myself clear as to my reservations in that area.

I would remind you, however, that we do have our obligation under the law to consider this matter, and the process as it's currently constituted allows Congress an opportunity to vote a legislative veto.

I can only assure you on my own part that we will exercise our responsibilities as they are currently constituted in a responsible manner.

The CHAIRMAN. Thank you. Now if you would like to proceed with your testimony.

STATEMENT OF GEORGE DOUGLAS, COMMISSIONER, FEDERAL TRADE COMMISSION

Mr. DOUGLAS. Thank you, Mr. Chairman.

Just a brief, informal aside as a matter of introduction, I am by background an economist. I'm only the second economist to serve on the Federal Trade Commission. It's unusual in terms of the historic practice of the Federal Trade Commission. I'm not at all apologetic for that fact because the Federal Trade Commission, after all, is in the business of dealing with the economy.

As a matter of fact, early in my career I worked in the area of finance and financial institutions. My dissertation, which was written at Yale University, was in the area of the pricing of risk in stock markets. As chance would have it, this very committee was holding hearings on the mutual funds industry during the summer in which I completed my dissertation. Two of your witnesses—Paul Samuelson, another economist, and Professor Henry Wallich, who is now on the Federal Reserve Board of Governors, cited my study very extensively before your group.

So I'm pleased to be here again today representing the Federal Trade Commission.

I have a brief statement which is a statement of the Commission, and if it is appropriate, I will read the statement at this time.

[The complete statement follows:]

STATEMENT OF
THE FEDERAL TRADE COMMISSION
PRESENTED BY
COMMISSIONER GEORGE W. DOUGLAS

Good morning, and thank you.

Mr. Chairman and members of the Committee, I am pleased to appear before you today on behalf of the Federal Trade Commission.

These hearings address an issue of major importance to the U.S. economy -- the future direction of the banking and financial services industries. I think we would all agree that this is an extraordinarily complex area that has grown faster, and in many ways outdistanced, the boundaries of existing regulation. It is therefore appropriate and timely that the Committee revisit this important sector of our economy. Do we need fewer regulatory constraints than the past? Do we need a different regulatory focus? Is regulation still necessary in all segments of the industry?

As you know, the Federal Trade Commission has little direct statutory authority over competition in the banking and financial community. Competition issues associated with depository institutions are addressed by other agencies. We do have enforcement responsibility for a number of consumer protection aspects of this industry, such as the Consumer Credit Protection Act as it relates to non-regulated financial institutions. We also have relevant experience in some related competition areas. First, the Commission has an active intervention program under which we and our staff have participated in some of the more complex deregulation issues to be considered by federal and state agencies in recent years, such as airline transportation, communications, and energy. In addition, in our analysis of antitrust issues we have gained a sense for how different financial regulations may affect competition in the industrial and manufacturing sectors of the economy.

For these reasons, we believe that the Commission can provide this Committee with a useful perspective and we welcome the opportunity to study and comment on the proposals that you will be considering in the months ahead. Although we have not studied these proposals in sufficient detail to comment on specifics today, I would nevertheless like to share with you some of the principles that the Commission will use to assess an appropriate course of future action.

The first and most basic principle that will guide us is that free and unfettered competition almost always serves the public interest best. We have found in most industries that competition efficiently allocates resources and leads firms to produce the type and amount of products that consumers desire at the lowest cost. We have also found that free competition enhances consumer welfare, leads to greater productivity and economic growth, and encourages technical change and innovation. Thus, when the Commission scrutinizes an industry in antitrust terms we look to see if there are any impediments to the vigorous competition necessary to achieve these economic benefits.

The financial services industry should be examined in the same way. Indeed, its central role in the economy necessitates such an examination. This industry performs the crucial role of bringing private resources and industrial needs together so that new economic opportunities can become a reality. Improving the efficiency of this process will equally benefit depositors (who will receive higher returns and improved financial services) and businesses (who will have lower costs and a greater diversity of capital supply). Greater efficiency in this process increases the incentives to save and invest, thereby aiding in capital formation. The ultimate beneficiary is, of course, the consumer.

Even a cursory analysis of the structure of the financial services industry indicates that it is not a model of competitive efficiency. This is particularly true of depository institutions. They are subject to a broad range of regulatory restraints that affect price, entry, and scope of service -- in short, all the major terms of trade. If such restraints were reached by private agreement, without statutory action, they would violate the antitrust laws. Moreover, such restraints often harm consumers. 1/

On the other hand, we recognize that the financial industry performs a crucial role in the monetary system upon

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1/ This has been particularly true in the past of provisions like Regulation Q, which by capping interest rates may have actually diminished returns to small savers and the supply of loans to small borrowers.

which the economy depends. Maintaining public faith in its stability and safety therefore requires some continuing regulatory safeguards that would not be warranted in other industries. However, the extent of existing regulatory restraints -- many of which have their historical genesis in the Depression experience -- may no longer be necessary.

So, to pause for a moment and sum up, the Commission's first general principle is a presumption in favor of competition as the primary regulator of markets. The second general principle we will look to is that of the least restrictive alternative. Where regulation is necessary and in the public interest, it should still be as narrow and unobtrusive as possible. Thus, direct control over an entire industry may not be necessary to achieve some specific public purpose.

Our third principle is that of neutrality in the regulation of capital markets. Many of the witnesses before this Committee have focused on competition among financial institutions. However, this focus overlooks what is perhaps an equally important issue: how the structure of the financial community affects competition in the economy at large -- that is, among the manufacturing and service companies that are the customers of the finance firms. Put another way, how does the structure of the financial community affect access to capital?

Competition requires that capital be equally available to firms that are equally situated. Our antitrust enforcement is premised on the existence of such unbiased capital markets. For example, in evaluating merger cases we assume free capital markets when assessing the height of entry barriers. Thus, it is vitally important that the laws and regulations governing the financial markets be neutral and contain no bias against any particular class of capital user.

Let me make a few points in conclusion. The Commission has experience with, and knowledge of the value of, the process of competition. We believe that deregulation in this industry promises to be highly beneficial. We are mindful that much flexibility in this industry has come about in spite of, rather than because of, government oversight. However, we are also aware that it is vital that financial institutions operate with the confidence of the public. We therefore commend this Committee's effort to fully reevaluate the state of competition in the financial services industry. We hope to continue working closely with you to identify problems and reach an economically sound and balanced approach.

The CHAIRMAN. Thank you very much.

CONSOLIDATIONS OF DEPOSITORY INSTITUTIONS REGULATORY AGENCIES

Chairman Isaac of the FDIC in his testimony advocated consolidation of depository institutions regulatory agencies for purposes of chartering and supervision and he recommended reorganizing regulatory activities along functional lines.

In other words, SEC would have jurisdiction over securities matters relating to banks and thrifts, Justice over antitrust enforcement. Under his recommendation, FTC would enforce compliance of consumer laws for all financial service providers.

What, in your opinion, would be the implications of such a change in view of the fact that FTC supervision is generally on a case-by-case basis while the consumer compliance supervision of the bank regulatory agencies is conducted through their regular examination?

Mr. DOUGLAS. Mr. Chairman, I understand this proposal has been made in general terms. The Commission has not addressed itself as a body to evaluating the merits of that proposal.

My own observations are that, in the absence of seeing the specific proposal, it would raise substantial problems for the Federal Trade Commission. It would vastly increase the Commission's enforcement obligations. We would be venturing into areas in which we currently have only partial expertise.

But more important, I think this proposal would have the danger of generating a duplication of regulation for the financial institutions.

In many cases, the regulation of consumer aspects of credit can be accomplished more easily through routine supervisory review of the banking institutions by the current examination system.

So, at least initially, I would be rather skeptical of that proposal.

The CHAIRMAN. In the last Congress, we virtually eliminated all price controls or interest rate ceilings. The other side of that coin, however, is we did not deregulate the ceilings that apply to credit extensions.

Senator Proxmire and I sponsored a bill, S. 730, which would eliminate all remaining usury ceilings.

Do you support the objective of eliminating usury ceilings?

Mr. DOUGLAS. Again, speaking for myself and speaking as an economist, I find usury laws to be a particular paradox in our economy. It is my belief and understanding that usury laws actually work to the detriment of the very people they are designed to benefit.

So my personal position would be in support of eliminating usury laws.

The CHAIRMAN. Do you believe that that elimination is more crucial now that we have deregulated interest rate ceilings that applied to deposit accounts?

Mr. DOUGLAS. Yes, I do.

The CHAIRMAN. During the 1970's a large body of consumer protection legislation covering the financial services industry was enacted. To name a few, we have truth-in-lending, equal credit opportunity, fair credit reporting, fair debt collection, fair credit billing, and so on.

You have both interpretative and enforcement authority with respect to some of these laws and with respect to others you generally have only enforcement authority since the Federal Reserve Board is charged with promulgating the regulations.

From your dual perspective as both a rule writer and an enforcer, do you have any general views or recommendations with regard to that body of law and its impact on the financial services industry?

Mr. DOUGLAS. Yes. This is, of course, a fairly new area for me. However, I have become acquainted with the application of these laws in the last few months, and I have observed some operations of these laws which to me appear to be economically irrational.

I might touch on a few basic points rather than trying to give you a comprehensive view, which we would be happy to supply at a later date.

One statute which I do not understand as an economist is the Cash Discount Act, which allows retailers to offer a cash discount but prohibits retailers from imposing a credit surcharge.

The CHAIRMAN. If I could interrupt you for just a moment and give you some understanding of the thought behind that, it was that retailers, if they were able to enact a surcharge, that would simply be an increase in the current price which most people considered already had paid for the credit and therefore if they were able to give a discount the price would stay the same. The discount would benefit the cash customer and if it went the other way the cash customer would not benefit and the credit would be paid for in the form of a surcharge. But that was the line of thinking, valid or not, behind having only one side of that coin opened up.

Mr. DOUGLAS. Well, that's not the way I would understand a competitive market operates. One might pose that scenario at the time the new statutory system is introduced. However, in most instances, the retailing market is highly competitive, and it would be impossible to predict that there would be any meaningful distinction between a surcharge and a discount. It seems to me to be a distinction without a difference.

TECHNICAL VIOLATIONS OF TRUTH-IN-LENDING ACT

My second point concerns an aspect of the Truth-in-Lending Act, which I endorse as being very useful in principle, especially its requirment that providers of credit clearly and distinctly convey to consumers the cost of credit in a uniform fashion to enable consumers to shop for credit and compare varying offers on an "apples and apples" basis. However, the current status of this law regarding seller's points and buyer's points seems to me also to be a distinction without a difference. Under the Truth-in-Lending Act, buyer's points are added into the computation of the interest rate. Seller's points are not. Again, considering competitive transactions as an economist, I would say there is no distinction between seller's points and buyer's points and that making such a distinction only invites distortion.

Currently we are investigating a number of examples of low interest rate financing by automobile dealers. In some instances we have discovered that it's possible for the seller of an automobile to buy down the loan from a third party and advertise an artificially low interest rate and at the same time present the purchaser with an option between an inflated price which goes along with this deceptively low advertised price of credit, and a lower cash price. I think that is an inconsistency which doesn't make sense to me.

Another subject I believe to be worthy of examination in the area of truth-in-lending, is civil liability for truth-in-lending violations. There appears to be a substantial amount of litigation over what might be called technical violations. It's my understanding that truth-in-lending, as currently constituted, still retains civil liability even for very trivial technical violations. I would suggest that there should be a de minimis exception to the civil liability provision in truth-in-lending.

Finally, the Commission recently forwarded to Congress its most recent annual report for the Fair Debt Collection Practices Act. In our letter of transmission, we specifically asked Congress to clarify the intended scope of the attorney-at-law exemption now contained in that statute. Debt collectors who are subject to the statute have informed us that they have observed attorneys establishing debt collection agencies and designating them as law firms and claiming exemption from Commission jurisdiction. We would like to have some clarification as to what Congress intends about the attorney-at-law exemption.

The CHAIRMAN. Let me say that I certainly agree with you on truth in lending. It is a law that I support, that I think is necessary, but I do not think it has fulfilled its intent because it is so overly complex that the average borrower doesn't understand what is being disclosed to him or her and creates a great paperwork burden. I have tried for years to change the civil liabilities penalties and been successful in the Senate and never successful in getting it through the House. There is one Congressman who is the self-appointed savior of every nut and bolt in truth in lending, even to the extent of not allowing a 1-year extension for agricultural and business credit usury preemption, even in that area—that's away from truth in lending—but in many areas if it's labeled "proconsumer" by anybody he stops it. And I think that truth in lending could be made to be the useful tool it was intended to be when it was first passed if we could simplify it and remove some of the overly restrictive provisions. Then people I think would be well served by the disclosure that it was intended to give them.

On page 4 of your statement you state that where it is found that regulation is necessary it should be as narrow and unobtrusive as possible and the least restrictive alternative should be utilized.

I would expect that you're aware that Treasury has recommended expanding the products and services that banks can offer, a large amount of deregulation, but they have also favored putting it into a separate subsidiary.

And in keeping with your least restrictive alternative philosophy, do you believe the separate subsidiary approach is essential or could these product lines be expanded in the bank itself and therefore creating fewer regulatory constraints?

Mr. DOUGLAS. Well, Senator, I think the crucial question here is whether one organizational form or another would materially affect the supervision of the banks by the bank examining authorities, the soundness of banks, and whether it would create a meaningful sheltering or insulation of the more traditional banking activities from the risks of the other activities.

My initial impression is that it would not be burdensome for bank holding companies to undertake expansion of their operations in the manner proposed by Secretary Regan. However, my observations on this point are really preliminary.

The CHAIRMAN. Do you think it would provide the insulation that Treasury talks about?

Mr. DOUGLAS. Would it?

The CHAIRMAN. Yes.

Mr. DOUGLAS. Again, I would have to defer to a thorough study of the particular problem.

The CHAIRMAN. Do you think it provided the insulation with the REIT?

Mr. DOUGLAS. I'm not familiar with instances of the operation of REIT's affecting the soundness of banks. I believe, however, that this would be a matter upon which those entrusted with insuring the banks' soundness would be better qualified to comment.

INTERSTATE MERGERS IN SMALL BANKER FAVOR

The CHAIRMAN. Mr. Baxter just testified that allowing interstate mergers is in small bankers' interests. I don't agree with that statement. How do you feel? Do you think interstate mergers, doing away with McFadden and Douglas, is in the interest of the small bankers?

Mr. DOUGLAS. Well, that's hard to call. In States in which bank charters are very restrictive, I think Mr. Baxter is probably correct—that the initial introduction of free interstate branching would probably cause most of the branching or mergers or new levels of activities to occur through acquisitions of existing institutions. As such, it would be expected to bid up the price of these banks.

However, insofar as bank entry has become less restrictive, it probably would injure small banks in the sense of providing greater competition. However, again, we approach these matters in terms of the perspective—the ultimate perspective in the long run—that we should be interested in protecting competition and consumers and not be terribly diverted by a concern over the protection of individual firms or competitors.

The CHAIRMAN. Thank you very much. I appreciate your testimony today.

Mr. DOUGLAS. Thank you, Senator.

The CHAIRMAN. Thank you very much.

The committee is adjourned until tomorrow when we will continue the hearings at 9:30.

[Whereupon, at 11:20 a.m., the hearing was recessed, to be reconvened at 9:30 a.m. on Thursday, June 9, 1983.]

FINANCIAL SERVICES INDUSTRY—OVERSIGHT

Part II

THURSDAY, JUNE 9, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present. Senators Garn, Hecht, and Lautenberg.

OPENING REMARKS BY CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Gentlemen, we are happy to have you before the Banking Committee to testify on conditions in the financial institutions industry.

The first panel we have before us is Mr. Robert B. Evans, president of the American Financial Services Association, accompanied by Dr. Thomas Durkin, director of research, American Financial Services Association, John F. Lee, executive vice president of the New York Clearinghouse, Paul Hefner, vice president of the First Interstate Bank Corp., Los Angeles, Calif., and chairman of the board, Electronic Funds Transfer Association, and Michael Nugent, special banking and telecommunications counsel, Electronic Data Systems, Washington, D.C.

Gentlemen, we are happy to have you with us.

Mr. Evans, if you would like to proceed.

STATEMENT OF ROBERT B. EVANS, PRESIDENT, AMERICAN FINANCIAL SERVICES ASSOCIATION, ACCOMPANIED BY DR. THOMAS DURKIN, DIRECTOR OF RESEARCH, AMERICAN FINANCIAL SERVICES ASSOCIATION, WASHINGTON, D.C.

Mr. EVANS. Thank you, Mr. Chairman, my name is Robert B. Evans. With me is Thomas A. Durkin, AFSA's Director of Research.

We welcome the opportunity to comment today on issues affecting our Nation's financial system, particularly, in our case, as they affect the consumer-oriented financial markets.

Above all, Mr. Chairman, our association stands for competitive financial markets. I know a lot of people have come up here and said that, but I think in our case you will find we truly believe that. In this context, Congress, and especially this committee should be applauded for steps taken in recent years to improve competitiveness of consumer-oriented financial markets.

BENEFITS OF COMPETITION

Now the benefits of competition in markets, are, of course, well known, but they bear repeating. First, competition assures that products or services, including financial services, are available to those who demand them at a minimum production cost for the quantity of service. This provides two basic benefits. One is the concept of efficiency. It simply means that the consumer gets the most for his money. Second, free competition also reduces potential conflicts of interest and concentrations of power. That, along with higher prices, are the hallmarks of uncompetitive markets.

One thing is vital to free competition, and that is, free entry into the market. I think we all agree on that. Without it, competitiveness ebbs and services become less efficient. Costs increase and, simply, the consumer does not get his money's worth.

There are thousands of financial service companies and in the past these have specialized in either product or geographic markets. But technological and communications improvements have lowered the costs for many of these companies, and—spurred on by inflation and high money costs—have brought about three key changes in the financial services market. First, we find companies are offering new combinations of products. Second, they're extending the scope of current markets, and finally, they're entering new product and geographic markets. The net result of this, along with your deregulation of 1980 and 1982, has been to introduce more competition into the marketplace. This seems like a good point to pose a question before this committee, at least as it seems to us.

Should Congress encourage further evolutionary developments, or should it stifle them, as some have seemed to urge, by restoring the past? We will pursue that question in a minute.

First, I'd like to take a look at our industry—the finance industry—and the role it's playing in the delivery of consumer financial services to our citizens.

WHAT IS A FINANCE COMPANY

First, what is a finance company? Generally speaking, I think most people know that finance companies do not take deposits. Further, they are not generally chartered like banks and savings and loans and credit unions and, therefore, are not restricted to certain financial or geographical markets. In this definitional sense, there are about 2,700 finance companies with assets of $180 billion. This is pretty small pickings compared to the commercial banks with assets of about $1.8 trillion. This takes on a different complexion, however, when you look at the chart on page 3, which exemplifies the gross distributions of consumer credit outstanding in the past 5 years.

On line 1 of that chart, you will see that in 1977 there was approximately $230 billion in consumer credit outstanding. At the end of last year this had grown—in nominal dollars—to $344.8 billion. That's about a 50-percent increase in the last 5 years. Interestingly, Mr. Chairman, if you adjust that increase by the Consumer

Price Index—which grew about 60 percent during this time—you will see in constant dollars consumer credit actually declined, because while it nominally gained 50 percent, the CPI grew about 60 percent.

This credit contraction provides a very marked and dramatic display of how severe the recession has been. Interestingly, on line 1-A, however, it is clear that the finance company portion of this market has improved from 19.5 to 27 percent. Credit outstanding has grown at a 5-year rate of 110 percent. During this time the industry's market share has not only increased from about 20 to 27 percent, but automobile and manufactured housing credit has been supplied in increasingly large measure by finance companies. Indeed, on line 2-A, you can see that slack in automobile financing has largely been taken up by three of our members, GMAC, Ford Motor Credit, and Chrysler Credit, and they have expanded their market share to 37 percent and their auto credit has grown of 221 percent in 5 years.

Equally important is the industry's emerging position as an important provider of mortgage credit, especially second mortgage credit, a product pioneered by the finance industry. Through advanced communications technology, geographic diversity, access to capital markets, and our growing share of the consumer credit market our industry is playing an increasingly important role in the provision of consumer financial services.

Briefly, to sum up the remaining aspects of our industry, it's virtually unnoticed, it seems, in the discussions of our chartered brethren, that finance companies provide almost every kind of financial service. I won't enumerate all of them. Briefly they go from small and large loans to credit cards, financing of mobile homes, leasing, educational credit, and so forth. Further, the finance industry has long had a role in consumer banking. Since 1909, it has—in more than 20 States—owned and operated what is know as industrial loan companies or industrial banks or thrift companies, at one time known as Morris plan companies. They have provided the public with depository services, often through companies affiliated with entities engaged in many other enterprises, including insurance companies, land developers, savings and loan associations, banks, stockbrokers, you name it.

These affiliations are interesting because through them finance companies have added to the competitiveness of financial markets for years without causing conflict of interests.

THE NONBANK BANK

We've noted earlier the changes being brought about by interest rates, technological and communications improvements. We have new delivery systems coming along. New companies are entering the field. Older line companies are restructuring their operations to provide new or changed products. Among the phenomena associated with this competitive ferment is the institution quaintly known as the nonbank bank. Actually, what is really new here is only the widespread discussion of such institution. Such institutions are not especially new as thousands of these institutions have operated for years. Our industrial banks, for example, have offered time deposits, made consumer and some commercial loans. They are eligible for FDIC insurance. Savings and loans, which are essentially consumer banks, have offered transactions and time accounts and make mortgage, consumer, and commercial loans. Most have FSLIC insurance.

More recently, and causing the most discussion, a few diversified institutions have started or acquired small consumer banks not unlike, but more limited than, industrial banks.

Now the purpose behind these acquisitions, essentially, today is that these diversified companies have acquired consumer banks for toehold entries into the payments system and to escape State usury ceilings. These banks offer transactions and time deposits, make consumer loans, and have FDIC insurance. They do not, however, make commercial loans. By themselves, none of these limited financial institutions causes any particular regulatory concern.

ARGUMENTS FAVORING CONTROLS OVER NONBANK BANKS

However, as you have heard recently, there are three major arguments being advanced as favoring imposition of new controls over the activities of these so-called nonbank banks, or as I would prefer to call them, consumer banks. These involve contentions about impact on monetary policy, safety and soundness of the financial system, and the possibility of concentration of resources and conflicts of interest that could arise from combining finance and commerce. We also suspect an unspoken fourth argument, and that is, protection of market and regulatory turf.

We have amplified at length on these particular arguments, but let me summarize briefly our response to each. First, monetary policy. Congress legislated uniformity in the area of reserves in 1980. Each of these so-called nonbank banks must comply in the same manner as more traditional banks with the reserve requirements established under the Monetary Control Act. So there is absolutely no cause or no argument whatsoever, no question that is raised by the existence of the nonbank banks, in terms of their effect on monetary policy.

The second argument concerns the impact of the banks on the safety and soundness of the banking system. We believe this to be a nonargument, for two reasons. No. 1, the asset portfolio of the nonbank banks is unique. They operate in the consumer market where there is relatively little risk, with highly liquid assets generating a constant, substantial cash flow. In other words, we don't have any loans in our portfolio to Third World developing countries, which have no cash flow, and the strong likelihood, perhaps, of not even being repaid. In general, consumer credit assets are characterized by short maturities and monthly amortization payments. They are not subject to sharp fluctuations in market value, and while not readily salable, consumer credit portfolios can be sold relatively easily to generate cash. So we're looking at entirely different assets, in which the small nonbank or consumer banks are dealing.

Second, beyond the normal operating considerations, the consumer-restricted nonbank bank is less able to upstream funds to parents or affiliates than full-line institutions able to make commercial loans. If there is any question about this, the expanded section

23(a) of the Federal Reserve Act makes this clear, that such inter or intracompany dealings could not take place.

The final and third argument advanced against allowing diversified institutions to own nonbank banks, is that it might increase concentration of resources or cause conflicts of interest arising from combination commerce and finance. This argument does not appear relevant for financial institutions operating only in the consumer marketplace. Entry of new firms should bring new capital and make consumer financial markets more competitive. It is hardly clear such entry will make industrial or commercial markets less competitive. Indeed, as we pointed out earlier, free right of entry, by its very nature, tends to combat concentration of resources and conflicts of interest.

In closing, Mr. Chairman, AFSA stands for competitive financial markets. For this reason, we encourage you to promote free market entry as a necessary prerequisite for competition. We believe that free entry and market competition will best insure the proper quality and diversity and availability of consumer financial services, and I hardly need add, at the lowest cost to consumers.

We share your committee's concern, and we think the concerns of all Americans, that the Nation be assured of safe and efficient financial markets. These concerns can best be addressed through ongoing inquiry by the Congress and, where needed, additional legislation.

To this end, we pledge our support for your continuing efforts to provide the financial system the full benefits of market competition. Thank you.

[The complete statement follows:]

Statement of
Robert B. Evans

My name is Robert B. Evans. I am President of the American Financial Services Association (AFSA). Accompanying me is Thomas A. Durkin who is Director of Research with AFSA and Adjunct Senior Research Associate in Finance at the Pennsylvania State University. AFSA welcomes the opportunity to comment today on issues affecting our nation's financial system, particularly as they affect consumer-oriented financial markets.

Competition is the Key

Above all, AFSA stands for competitive financial markets. In this context, Mr. Chairman, Congress - especially this Committee - should be applauded for steps taken in recent years to improve competitiveness of consumer-oriented financial markets. These steps include many of the provisions of the Depository Institutions Acts of 1980 and 1982.

The benefits of competition in markets are, of course, well understood, but bear repeating. First, competition assures that products or services, including financial services, are available to those who demand them at minimum production cost for the quantity of service. This is the concept of efficiency. Simply stated, competition causes resources to be allocated to their best productive uses with minimum loss of resources along the way. Second, free competition also reduces potential conflicts of interest and concentrations of power that, along with higher prices, are the hallmarks of uncompetitive markets.

To insure these benefits of competition, free entry into the market is an important prerequisite. As soon as substantial barriers to free entry are put in place, the competitiveness of markets begins to deteriorate and the benefits to customers start to decline. As competitiveness ebbs, the quality of service declines, the cost rises, or both.

The Changing Consumer Financial Services Market

Consumer financial services are offered by thousands of companies. Historically, many of these companies have specialized in particular parts of product and geographic markets for cost reasons, but also because regulation has restricted them to certain markets. But today technological and communicati[illegible] improvements are lowering costs for all producers. These cha[illegible] are permitting companies to offer new combinations of products, to extend the scope of their current markets, and to enter new product and geographic markets. Overall, such changes should improve the quality of products and services, and make the markets more competitive. The question before this Congress is whether we want to encourage further evolutionary developments or stifle them by attempting to restore the past.

A Look at the Finance Industry

The terms "finance company" or "financial company" have a generic use referring to all financial intermediaries that acquire funds from one source and apply them in other uses. However, most often the terms are used to connote those financial institutions that do not accept consumer deposits or do not have a particular type of state or federally granted charter - such as a bank, savings and loan association, or credit union charter - that historically has restricted such chartered institutions to certain financial markets. Defined this way there were more than

2700 finance companies at last count, the five-year census most recently undertaken by the Federal Reserve Board in June 1980. Total assets in early 1983 exceeded $180 billion.

It may be helpful to take a look at the finance industry's contribution to consumer financing in the U.S., as exemplified in the table below.

Growth and Sources of Consumer Installment Credit Outstanding
1977-1982

	Amount Outstanding 1977 ($ Billions)	Share of Market 1977 (Percent)	Amount Outstanding 1982 ($ Billions)	Share of Market 1982 (Percent)	Percent Growth 1977 to 1982
1) Total	230.6	100.0	344.8	100.0	49.5
A) Finance Companies	44.9	19.5	94.3	27.3	110.0
B) Others	185.7	80.5	250.5	72.7	34.9
2) Automobile Credit	82.9	100.0	130.2	100.0	57.0
A) Finance Companies	15.2	18.3	48.8	37.5	221.0
B) Others	67.7	81.7	81.4	62.5	20.2
3) Mobile Home Credit	15.0	100.0	19.0	100.0	26.7
A) Finance Companies	3.1	20.7	5.0	26.3	61.3
B) Others	11.9	79.3	14.0	73.7	17.6
4) All Other Consumer Installment Credit*	132.7	100.0	195.6	100.0	47.4
A) Finance Companies	26.6	20.0	40.6	20.8	52.6
B) Others	106.1	80.0	155.0	79.2	46.1

* Includes home improvement loans, "other consumer goods" credit, personal loans, and revolving credit.

From this table it can be seen that: 1) the finance industry's 5 year growth rate is 110% compared to 34.9% for all other extenders of consumer credit; 2) the industry's market share has increased from 19.5% to 27.3%; 3) automobile and manufactured housing credit has been supplied in increasingly large measure by finance companies, this during a difficult period for both autos and housing. Not apparent, but equally important, is the industry's emerging position as an important provider of mortgage credit, especially second mortgage credit, a product pioneered by the finance industry.

Broad Diversity of Financial Services

Virtually unnoticed - it seems - in discussion of their chartered brethren, is that finance companies provide almost every kind of financial service. On the consumer side finance companies provide small consumer loans, large consumer loans, first mortgages, second mortgages, credit card services, retail financing of automobiles, mobile homes, and appliances, leasing, home repair loans, educational credit, insurance, and other products. For businesses finance companies provide working capital loans, equipment financing, leasing, accounts receivable financing, factoring, and wholesale financing. Finance companies also issue a variety of liability products to the public at large including stocks, bonds, subordinated notes, and commercial paper in varieties of sizes and maturities.

The Finance Industry's Role in Consumer Banking

Beginning as long ago as 1909 and extending to the present in more than twenty states, finance companies operating as industrial banks, industrial loan companies, thrift companies, or loan and thrift companies have provided the public with deposit services. And, interestingly, finance companies provide all these services through companies often affiliated with entities engaged in many other enterprises. Finance companies are affiliated with light and heavy manufacturing companies, retail chains, airlines, communications and broadcasting companies, car rental companies, computer specialists, banks, movie studios, land development and management companies, savings and loan associations, insurance companies and stockbrokers; in short, with virtually every kind of enterprise. These affiliations are interesting because through them finance companies have added to the competitiveness of financial markets for years without causing conflicts of interest.

Technological and communications improvements we have noted- along with high interest rates - have encouraged development of new financial products and delivery systems. Institutions have combined old products in new ways and are offering innovative new financial services. New companies are entering the field and older-line companies are restructuring their operations to provide new or changed products. Among the phenomena associated with this competitive ferment is the institution quaintly known as the "nonbank bank." Actually, what is really new here is only the widespread discussion of such institutions, since such institutions are not especially new.

"Nonbank banks" are finance or financial companies, using these terms generically, that engage in bank-like enterprises but whose corporate parents are not subject to the restrictions specified in the Bank Holding Company Act of 1956 and its amendments. Thousands of these institutions have operated for years. Industrial banks, for example, offer chiefly time deposits and make consumer and some commercial loans. They are eligible for FDIC Insurance. Savings and loan associations offer transactions and time accounts and make mortgage, consumer, and commercial loans. Most have FSLIC insurance. Most recently and causing the most discussion, a few diversified institutions have started or acquired small consumer banks not unlike but more limited than industrial banks. They have acquired these institutions for toehold entries into the payments system and to escape state usury ceilings. They offer transactions and time deposits, make consumer loans, and have FDIC insurance. By themselves none of these limited financial institutions causes any particular regulatory concerns.

However, three major arguments are currently being advanced as favoring imposition of new controls over the activities of "nonbank" banks - involving contentions about 1) impact on monetary policy, 2) safety and soundness of the financial system, and 3) the possibility of concentration of resources and conflicts of interest that could arise through combining finance and commerce. We also suspect an unspoken fourth one, protection of market and regulatory turf. The first argument concerns the banking system as an important element in the transmission of monetary policy. By its nature monetary policy is an esoteric and highly technical area, although for constitutional as well as practical reasons it certainly is a proper area for ongoing Congressional watchfulness. However, the nonbank bank issue concerns ownership and affiliations of financial institutions, not essential elements of monetary policy. Nonbank banks issuing demand deposits are subject to reserve requirements the same as banks of more traditional form. Congress legislated uniformity in this area in the Monetary Control Act of 1980. While ongoing oversight regarding the proper level of reserves, the payment of interest on reserves, the types of accounts on which to require reserves and other technical matters of monetary policy certainly seems reasonable and appropriate, these are not questions raised by the existence of nonbank banks. Even if their permissible affiliates may differ under the Bank Holding Company Act, the monetary-policy status of banks and nonbank banks is exactly the same under the Monetary Control Act.

The second argument concerns the impact of nonbank banks on safety and soundness of the banking and financial system. The issue arises because depository institutions are custodians of much of the nation's liquid wealth as well as of its payments system. According to the argument, the public interest requires government to establish a protective safety net and to monitor and control the system. Certainly, everyone contends that maintaining a safe and sound banking and payments system is a proper role for government. Thus, the ultimate question for nonbank banks affiliated with other enterprises is whether they increase the overall riskiness of the financial system.

In examining this question it is useful to recall the legal reason for the nonbank bank anomaly. Banks for purposes of the Bank Holding Company Act are, of course, institutions offering both demand deposit accounts and commercial loans. In contrast, the nonbank banks causing most of the current discussion produce only one of these types of products, thereby escaping the strictures of the Act. However, for reviewing the safety and soundness issue for consumer-oriented nonbank banks only one type of institution is important - nonbank banks that take demand deposits but do not make commercial loans. It seems that such institutions - limited to their consumer loan portfolios are less, rather than more risky than other depositories. Their very nature as consumer-oriented rather than commercial institutions would tend to minimize riskiness. Both operating factors and current regulations suggest this outcome.

In the first place, nonbank banks operating in the consumer market are likely to have relatively low risk, highly liquid assets generating a constant and substantial cash flow. In general, consumer credit assets are characterized by short maturities and monthly amortization payments. They are not subject to sharp fluctuations in market value, and while not readily saleable instantaneously, the consumer credit portfolio can be sold relatively easily to generate cash. In contrast, typical commercial bank portfolios may be more illiquid and subject to sharper market price fluctuations. Some assets such as many commercial accounts and state and local governments' securities are hardly marketable at all. Such problems would not appear to affect the consumer-oriented nonbank banks.

Beyond such normal operating considerations, a consumer-restricted nonbank bank would be less able to upstream funds to parents or affiliates than full-line institutions able to make commercial loans. This fact would tend to enhance currently existing restrictions on transactions among affiliates such as those found in Section 23A of the Federal Reserve Act only recently revised, clarified, and strengthened in the Garn-St Germain Act. Thus, at present, it does not seem that safety and soundness considerations are serious enough to argue for wholesale elimination of these consumer-oriented financial institutions from the market for financial services.

The third argument advanced against nonbank banks is that they might increase concentrations of resources or cause conflicts of interest arising from combining commerce and finance. Large-scale industrial/financial conglomerates are sometimes pictured as possible outcomes. Indeed, such a possibility is an issue of national concern. However, as with the other arguments against nonbank banks, this argument does not appear relevant for institutions operating in the consumer marketplace. Entry of new firms should bring new capital and make consumer financial markets more competitive; it is hardly clear such entry will make industrial/commercial markets less competitive. Indeed, free right of entry by its very nature tends to combat concentrations of resources and conflicts of interest. While, obviously, the merits of large-scale combination of commerce and commercial banking might be debated much farther, it seems that much of the criticism breaks down when focusing on consumer-oriented services.

In sum, AFSA stands for competitive financial markets. For this reason AFSA encourages you to promote free market entry, a necessary prerequisite for competition. We believe that free entry and market competition will best assure the proper quantity, diversity and availability of consumer financial services.

Conclusion

AFSA shares this Committee's concerns - and, we think, the concerns of all Americans - that the nation be assured of safe and efficient financial markets. These concerns can best be addressed through ongoing inquiry by the Congress and - where needed - additional legislation. To this end AFSA pledges its support for your continuing effort to provide the financial system the full benefits of market competition.

The Chairman. Thank you, Mr. Evans. Mr. Lee.

JOHN F. LEE, EXECUTIVE VICE PRESIDENT, NEW YORK CLEARING HOUSE ASSOCIATION, NEW YORK, N.Y.

Mr. Lee. Good morning, Mr. Chairman, Senator Hecht.

I am John Lee. I run the New York Clearing House.

I am pleased to be with you this morning.

I would like to present a few of our association's views on two matters that concern all money center banks. These two matters are the archaic statutory structure which now shackles banks and is the growing pains affecting the payments mechanism.

Our association has a history of speaking out on these matters. As long ago as 1853, before the Civil War, before we had a central bank or an Office of the Comptroller of the Currency, our records indicate that we consulted with the Congress and the Treasury sometimes, in taking the role of a surrogate central bank.

In our prepared statement today, which I submitted for the record, we address again the issues raised 2 years ago, when the president of the clearing house testified before you, and he raised the pressing need to amend or repeal anachronistic banking laws. He noted that the public is demanding a wide array of financial services, which commercial banks are largely prohibited from providing, and that nonbank competitors in the industry are now providing many of those services without geographic or regulatory restriction.

In response to these developments, he proposed four fundamental legislative revisions, all of them involving the removal of price, product, place, or procedural restrictions which now shackle commercial banks. And with the exception of the fade out of the reg Q interest rate ceilings, and in particular, the introduction of the new accounts which are competitive with money market accounts, which the clearing house applauds, our testimony in 1981 is as pertinent now as it was then. Indeed, the only real difference is that 25 months have passed without any meaningful action to solve the problems that were then identified.

Accordingly, we have attached a copy of our 1981 testimony. We have not attempted to be encyclopedic in our prepared statement. That would have been redundant after Bill Kennedy testified on May 3 for the American Bankers Association.

His statement addressed all of the issues in detail, and except for its failure to espouse full interstate banking, we believe it is a fine exposition of banking's posture and its aspirations.

Also, our prepared statement does not express as forthrightly as it might the surprisingly pleasant experience of the banking community as a result of the passage of the Garn-St Germain Act. Some of us were lukewarm in support of that bill as it was moving through the Congress.

I suppose we focused on the things that the bill did not do, but as a result of that act depository institutions now have an instrument that is fully competitive with the money market funds, and, Mr. Chairman, you deserve considerable credit for pushing that bill through to enactment.

PUBLIC DEMANDING AN ARRAY OF FINANCIAL SERVICES

If there is one point I would like to make today, it is that the dramatic changes in the financial services industry, which we first identified 2 years ago, are irreversible. Such changes are an inevitable response to the demands of the public, the conditions of the markets, and the pace of technological change.

The public is demanding an array of financial services, many of which were not even imagined or technologically possible when the basic legal structure of the banking industry was enacted.

Moreover, the nonbank competitors in the industry—investment banking firms, insurance companies, retailers—are ready and able to provide those services without geographic or regulatory restrictions.

These are developments which require a response if banks in the United States are to participate fully with their nonbank competitors and foreign counterparts in providing the products and the services which the market is demanding and which will—let there be no mistake—be provided by someone.

If the benefits to the public of bringing banks in as full-fledged participants are to be achieved, Congress must act now. Congress must also act now if commercial banks are to remain viable competitors in providing financial services on a national and worldwide basis.

The Reagan administration seemed willing to champion a bill last January that would have given banks new powers and would have simplified the regulatory procedure for approving bank holding company acquisitions in approved lines of business.

Our association worked with the ABA toward shaping such a bill, and we sincerely regret the distraction caused by the campaign to repeal the TEFRA provisions which provide for withholding on interest and dividends. We do not favor withholding, but Congress did enact it into law and we respected that.

Unfortunately, the enormous effort made to repeal it has overshadowed the need for a banking bill this year. Although I am neither a banker nor a political scientist, I would not be straying too far afield if I repeat the maxim that the laws should respond to the needs of the governed, in this instance the users of financial services, and not vice versa.

Those users are demanding products and services, which will be provided in any event, but will be provided at the cheapest price, most abundantly, and most competitively if artificial barriers to competition are removed.

Two years ago we urged immediate action. Immediate action is even more important today. Too much time has already been lost.

While our prepared statement says nothing about the payments mechanism and its growing pains, the New York Clearing House is deeply involved in the payments system, and its development is of great concern to our members. We have always processed checks, and we have pioneered in the electronic funds transfer business.

Our interbank payments system was the first computerized funds transfer network in the world. Our automated clearing house is the largest, and it is the only privately operated ACH processor in the country.

With respect to all of our services, we are proud to have worked closely with the Federal Reserve Bank of New York, which provides the final settlement mechanism. Nevertheless, today we note an increasing friction between the Federal Reserve System and the private sector.

As an association, we have adopted a moderate stand on the issues being drawn, and generally we have refused to take public positions, for we believe our friends at the Fed will understand in time what we have maintained for many years: healthy, unrestricted competition in the payments system benefits the American public.

The antitrust laws prevent commercial banks from engaging in predatory practices, and in time we believe the Fed, too, will come to realize that such practices are unproductive and self-defeating, no matter who engages in them.

In conclusion, I would like to thank the committee for the opportunity to testify today. I would be happy to answer any questions if I can.

Thank you.

[The complete statement follows:]

STATEMENT OF JOHN F. LEE, EXECUTIVE VICE PRESIDENT OF NEW YORK CLEARING HOUSE ASSOCIATION

I am John F. Lee, Executive Vice President of the New York Clearing House Association, an association founded in 1853 and composed of 12 major commercial banks located in New York City.

We appreciate this opportunity to testify before your Committee because we believe that statutory recognition of changes which have occurred and are continuing to occur in the financial services industry is overdue, and the time has passed for mere review and analysis. Two years ago last month Gordon Wallis, Chairman of the Board of Irving Trust Company and at the time President of the Clearing House, testified on behalf of the Clearing House before your Committee on the same basic issue being addressed today -- the pressing need to amend or repeal anachronistic banking laws. He noted that the public is demanding a wide array of financial services which banks are largely prohibited from providing and that nonbank competitors in the industry--investment banking firms, financial service companies, insurance companies and retailers--are now providing many of those services without geographic or regulatory restriction.

As indicated by his testimony, the present basic statutory structure, which was adopted in 1927, 1933 and 1956, is outmoded. The severe constraints on U.S. banks are unparalleled in any other sector of our economy or in any other country, and are inconsistent with the underlying ationale of our economic system. These constraints were adopted in response to problems and issues which are non-existent or irrelevant today. They were adopted at times when the financial services industry to which they apply was vastly different from that industry today: many of the services now offered to the public were not even imagined or technologically possible when the basic legal structure defining the powers of commercial banks was enacted.

Accordingly, in 1981 the Clearing House proposed four fundamental revisions to our basic statutory structure: (1) removal of the limitations on the provision of securities services by banks which are imposed by the Glass-Steagall Act; (2) removal of the limitations on interstate banking which appear in Section 3(d) of the Bank Holding Company Act (the so-called "Douglas Amendment") and in the McFadden Act; (3) removal of the limitations on bank related activities in Section 4(c)(8) of the Bank Holding Company Act which prevent bank holding companies from providing the range of financial services offered by their nonbank competitors; and (4) repeal of Regulations Q and D, which prevented banks from paying realistic interest rates on consumer deposits and impose reserve costs not incurred by foreign banks and other competitors.

I must say that I have a sense of deja vu and at the same time of heightened concern. With the exception of the phase-out of the Regulation Q interest rate ceilings, and in particular the introduction of new accounts competitive with money market funds (which the Clearing House applauds), our previous testimony is as pertinent now as it was on May 6, 1981. Accordingly, I am enclosing a copy or our 1981 testimony.

Indeed, the only real difference between May 6, 1981 and today is that 25 months have passed without any meaningful action to solve the problems previously identified. If the benefits to the public of bringing banks as full-fledged participants into the financial services industry are to be achieved, Congress must act now. Congress must also act now if commercial banks are to remain viable competitors in providing financial services on a national and worldwide basis.

The Strengthened Competition

Since 1981, the revolution in the financial services industry has continued at an accelerated pace, strengthening significantly the competitors faced by banks. What has emerged are financial service corporations which provide bank services without being subject to bank regulation. Virtually all of the major finance companies -- Household, Associates, Beneficial, Commercial Credit and Avco -- have acquired or are in the process of acquiring so-called "nonbank" banks as a result of the Bank Holding Company Act's bifurcated definition of "bank". Utilizing the same statutory provision, many of the nation's major investment banking houses, such as Merrill Lynch, Prudential-Bache and E.F. Hutton, and the largest mutual fund complexes, such as Dreyfus and Fidelity, have acquired or are acquiring banks. Major retail chains such as J.C. Penney and McMahon Valley Stores, a major California furniture operation, have followed suit. The asset and deposit powers of savings and loan associations have been sharply expanded to the point where, in some states at least, they are virtually identical to those of commercial banks. Recognizing the opportunity to acquire an institution that is a bank in everything but name, major financial service companies such as Merrill Lynch and American Express have rushed to acquire savings and loans. As the Federal Reserve Bank of Atlanta concluded in its May Economic Bulletin, "The potential impact of 'near-banks', such as Sears, American Express and Merrill Lynch, on the financial markets is enormous."

These developments contrast starkly with the banking industry's inability to enter the very same fields. Bank holding companies are not permitted to open "nonbank" banks if they receive deposits, except in very limited circumstances. Bank holding companies are permitted to acquire savings and loans only if they are moribund, and even then only under a system which favors other bidders.

In a closely related development, there has been a continuation of the trend started by the combination of Prudential Life with Bache and of American Express with Shearson Loeb Rhoades. Shearson was able to use the financial strength of American Express to acquire two major regional investment banking firms, and American Express itself has acquired a major European bank.

Of particular relevance is the acquisition by Sears Roebuck & Co., the world's largest retailer and already one of the nation's largest financial services companies, of Dean Witter Reynolds, the third largest investment banking concern in the United States based on the number of employees, the fourth largest based on the number of offices, and the ninth largest based on capital (all at December 31, 1982). Sears had 1982 retail sales of approximately $18.7 billion through over 800 retail merchandising outlets in all 50 states and the nation's dominant catalogue business. In the financial services industry, Sears owns a major savings and loan in California (Allstate Savings & Loan), the nation's second largest property and casualty insurer (Allstate Insurance Company) a[illegible]tion's largest mortgage banking concern (Coldwe[illegible] The addition of Dean Witter to the Sears group will combine under one corporate umbrella the country's most widespread consumer access, a major insurance company, a major savings and loan, and an investment banking firm which managed or co-managed public offerings or acted as agent in private transactions raising approximately $16.8 billion during 1982.

Sears illustrates the continuing trend toward financial service companies which are able to provide through their various "arms" any financial service a customer may desire. In the case of the retail customer, this includes transactional and investment deposit accounts, the widest possible variety of consumer lending (including normal retail credit, second mortgage loans and margin accounts), insurance and brokerage. For the business customer, additional features are underwriting, private placements and loan syndications.

Sears also illustrates the ability of one "arm" to help the other market its services. During 1982, Dean Witter, acting for its own customers, began to market Allstate Savings & Loan time deposits through Dean Witter's 345 offices throughout the 50 states. Similarly, it has been reported (in the June 2, 1983 American Banker) that Sears plans to establish "financial centers" in its retail outlets which will combine the services of its subsidiaries -- Allstate Insurance Company for insurance, Coldwell Banker for real estate, Dean Witter for brokerage, and in California, Allstate Savings for deposit and loan services. Sears reportedly plans to establish 100 of these centers by year end, 250 by the end of 1984, and 600 by 1986.

The marketing of a depository institution's deposits by an affiliated financial service organization has particularly important implications for the future of interstate banking and the competitive position of commercial banks. In addition to the Sears-Dean Witter-Allstate program, Dreyfus Corporation apparently intends to use the nation's largest mutual fund complex as a source of deposit customers for its two newly-acquired banks. Similarly, last week Merrill Lynch was reported to have filed with the New Jersey Banking Department for permission to organize a state-chartered New Jersey bank. If the charter is granted, Merrill Lynch will be able to solicit time deposits for its new bank subsidiary from any of Merrill Lynch's approximately 430 offices in the United States, and its new bank subsidiary could turn those deposits into virtually any kind of loan or investment permissible for a New Jersey bank.

In short, the major financial service organizations are able to provide banking services nationwide and to combine those services with a wide variety of nonbank financial services. Both this geographical and product breadth are precluded for banks. Further, in the case of the nonbank banks, the attempt to impose a regulatory moratorium has been weakened by the "loopholes" inherent in such a moratorium, principally the inability of the moratorium to reach the acquisition of existing nonbank banks, which are subject to different regulatory standards pursuant to the Change in Bank Control Act.

Further technological developments are likely to result in even more fundamental changes in the financial services industry than the changes which have occurred in recent years. The limits of technology's potential impact on financial services have not yet even been approached. However, because of the legislative contraints placed on commercial banks, their financial service competitors are far better placed to take advantage of these technological breakthroughs.

The day is coming soon when the consumer, sitting before his home computer terminal, will be able to instruct his bank or broker to buy or sell, pay his bills, take out a loan, and open new deposit accounts. Through electronic terminals, a small businessman in Iowa could invest his funds through a bank in Chicago, pay bills through a bank in Boston and discount receivables with a bank in Dallas.

The limits on banks' product and geographic expansion make it difficult for them to utilize these new delivery systems. Their competitors -- Merrill Lynch, Prudential, Sears, American Express and the like -- are unhampered by such restraints and have the consumer access and resources to take advantage of these technological advances.

Foreign banks as well as domestic nonbank financial service companies have made competitive gains in the U.S. market for financial services since 1981 at the expense of domestic commercial banks. Commercial and industrial loans to U.S. borrowers from the U.S. operations of foreign banks increased 16.5% during the 12 months ended June 30, 1982 over the prior 12 months, compared to a 9.9% increase for U.S. banks. At June 30, 1982, commercial and industrial loans to U.S. borrowers by the U.S. operations of English and Japanese banks alone were 14% of such loans by all U.S. banks. The increasing reliance by U.S. corporations on credit extended by non-U.S. banks is a disturbing indicia of the lack of competitive strength on the part of U.S. banks.

Proposals

If there is one point I would like to make today it is that the dramatic changes in the financial services industry are irreversible. Such changes are an inevitable response to the demands of the public, the conditions of the markets and the pace of technological development. It is a fact which requires a response if banks in the United States are to participate fully with their nonbank competitors and foreign counterparts in providing the products and services which the market is demanding and which will, let there be no mistake, be provided by someone.

Accordingly, the Clearing House continues to support two proposals:

(i) removal of the competitive imbalances with respect to the breadth of financial services which are created by the Glass-Steagall Act and Section 4 of the Bank Holding Company Act; and

(ii) repeal of the McFadden Act and the Douglas Amendment restrictions on interstate banking.

Let me make a few comments on each proposal.

Bank Products and Services

Any informed debate over the limitations imposed on bank products and services must start with the recognition of two basic facts. First, consumers demand and deserve the ability to obtain a full range of financial services from a single institution. Second, this demand can be met in large part by nonbank financial institutions and retail organizations.

We acknowledge that during the last two years one major legislative liberalization (the authorization of bank money market accounts) and several minor judicial and regulatory advances have occurred. But these developments have been haphazard and limited, and in some cases remain the subject of prolonged litigation. As a case in point, the permissibility of limited bank brokerage and commercial paper activities is still being litigated by the Securities Industry Association, protecting its turf irrespective of the public benefits which will accrue from the exercise by banks of these powers. Also, the General Counsel of the FDIC has recently taken the position that the brokerage services permissible for banks may not include investment advice.

Moreover, the inroads of investment banks and other financial institutions into the traditional business of commercial banking are far more significant and pervasive than the minor increases accruing to banks. Indeed, the term "inroads" understates the developments. Nonbank financial institutions have long been able to offer numerous financial products which banks cannot: mutual funds, full scale brokerage and insurance. And now they can offer a full range of bank services as well. On the lending side, financial institutions have precisely the same opportunities as banks and they take advantage of them. On the deposit-taking side, where is the line between credit balances in a cash management account which on a daily basis are swept into a broker's money market fund and a deposit? Further, as I have discussed, an increasing number of securities companies and retail organizations are actually acquiring banks for their deposit-taking capacity.

We continue to believe that the time for remedial legislative action is now. To quote our 1981 testimony:

> "Congress should not reduce the debate to whether commercial banks should or should not engage in one or another narrowly defined activity. At home, American consumers will not wait for these issues to be sorted out."

It is questionable whether the concerns which gave rise to the limitations still in effect on commercial bank powers responded to real problems, and thus whether the limitations were ever justifiable. But, in any event, the financial environment of the 1930's, and the expectations of the consumer, were vastly different from today. And it is today's world that we must now address. We continue to believe that the two principal objections raised against deregulation -- concentration of power and conflicts of interest -- are unsupported by the facts and do not raise issues peculiar to the banking industry.

We do not see how there can be anything wrong with banks offering insurance services when Prudential, Sears and

American Express offer both banking and insurance services. We do not see how there can be anything wrong with banks offering securities services when Merrill Lynch, the nation's giant mutual fund complexes and again Prudential, Sears and American Express offer both banking and securities services. We do not see how any conflicts potentially involved in additional bank powers can exceed those which have long existed in the securities industry. We do not see how concentration of resources can be a legitimate concern when the present system fosters concentration by encouraging the nation's giant nonbank institutions -- Sears, J.C. Penney, Prudential, American Express and Aetna -- to enter banking.

If we are to have a healthy banking system competitive with domestic nonbank competitors and the international financial community, commercial banks must truly be viewed as financial service organizations able to respond to the market's demands for a full range of services.

Interstate Banking

Within the past 30 months, an administration from each party has advocated prompt consideration of the interstate banking restrictions with a view toward their elimination. The 1981 Carter Report described the present restrictions as "increasingly ineffective, inequitable, inefficient and anachronistic", and called for their repeal. The 1983 Reagan

Report stated: "It is time to reconsider these geographic restrictions because they are probably not in the best interests of consumers or the more efficient financial institutions."

Today the real question with respect to interstate banking is not whether it will occur, but rather how it will occur. Our national interest requires congressional action at the earliest possible opportunity to repeal the McFadden Act and the Douglas Amendment.

In every area where Congress and the regulators have failed to bar interstate banking, it occurs -- predominantly outside of traditional commercial banking. A prominent example is the Federal Home Loan Bank Board's permitting 20 of the nation's largest thrifts to cross state lines. Similarly, the entry of the giant national financial companies into banking has made bank deposit and loan services available through the nationwide retail outlets of various affiliated companies. Indeed, because brokerage houses can directly offer loans and deposit services in the form of cash management accounts, they can directly provide banking services throughout the country. In other words, "nonbank" financial institutions already have the equivalent of interstate banking.

There has been some relaxation of the barriers to interstate banking for commercial banks, but this has been minor and haphazard and consequently detrimental to the interests of the consuming public. For example, several New England states have enacted so-called compact legislation where interstate banking is available but only on a prescribed regional basis. Does it make sense to limit a resident of lower Connecticut to branches of a Boston-owned bank, and to deny him access in his home town to branches of a New York bank which has branches only four miles away as well as where he works? Is it appropriate to make medium sized banks in Connecticut vulnerable to takeovers by much larger Massachusetts banks, but then to limit sharply the number of bidders and potentially deprive the shareholders of the highest price?

Further, a piecemeal approach to interstate banking does not work. The provision of the Depository Institutions Act of 1982 permitting cross state acquisitions in emergency situations illustrates the point. Recent experience suggests that the congressional intent is being frustrated. In Tennessee an in-state bidder was awarded a failed bank by being permitted to bid on a special basis denied to everyone else, despite the fact that the result is one of the most highly concentrated banking markets in the country. More recently, a possibly feasible acquisition of a failing bank by an out-of-state acquiror was rejected in favor of an in-state acquisition which cost the U.S. government at least $100 million more than the first solution.

The inherent flaws in this process of interstate banking by loophole and ad hoc measures are well summarized in the November, 1982 report of the Southern Regional Banking Committee:

> "Devising means to circumvent these restrictions [on interstate banking] is more costly in terms of operation and capital utilization than would be the case if the regulatory barriers did not exist. The restrictions also place commercial banking firms at a disadvantage when trying to compete with the largely unlimited expansion activity of less regulated nonbank financial service firms. It is evident that the legislative barriers to interstate banking originally devised to protect banking operations are now making it more difficult and costly for banks to compete in the evolving financial services environment."

My point is simply this. Interstate banking is here -- to a substantial extent for nonbank competitors in the financial services industry and to a minor, erratic extent for banks. The real question now is what to do about it: should it continue on its present haphazard course, or should it be given some order by legislative action putting all banks on an equal footing among themselves and with their nonbank competitors? The latter course is clearly mandated by the need to provide the capital resources, technology and services required by the public, and to foster competition.

Conclusion

Underlying all these issues must be a concern about the financial condition of the banking industry. Although the deregulation of deposit interest rates has improved banks' competitive position, the profitability of many banks may be adversely affected in the absence of other legislative and regulatory reforms. It is essential that the legislative and regulatory reforms which would make it possible for banks to improve their profitability occur. If you believe, as I do, that the health of our banking system is a precondition to the health of our economic system, then these artificial barriers to effective competition must be removed -- and at the earliest possible date.

At the risk of mingling banking and political science, I will not be straying too far afield if I repeat the maxim that laws should respond to the needs of the governed, in this instance the users of financial services, and not vice versa. Those users are demanding an array of products and services which will be provided in any event, but will be provided at the cheapest price, most abundantly and most competitively if the artificial barriers to competition are removed. Two years ago we urged immediate action. Immediate action is even more important today. Too much time has already been lost.

TESTIMONY OF THE NEW YORK CLEARING HOUSE ASSOCIATION BEFORE THE U.S. SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS—MAY 6, 1981

I am Gordon Wallis, chairman of the board of Irving Trust Company and president of the New York Clearing House Association, an association founded in 1853 and composed of 12 major commercial banks located in New York City.

We appreciate the opportunity to testify in these hearings because we believe that the revolution occurring in the financial services industry compels major changes to rationalize our banking laws. These changes are necessary for two basic reasons:

First, to enable the American public to enjoy the full benefits of competition within the financial services industry;

Second, to enable United States commercial banks to continue to serve the American economy and to function as viable competitors nationally and worldwide.

The cornerstone of our American economic system has always been freedom of competition. Freedom of competition delivers the most and best goods and services at the lowest price to the American public, while at the same time encouraging the innovation, progressive entrepreneurial spirit and economic opportunity which are so much a part of our social and political fabric.

As has been increasingly realized, the freedom to compete is stifled by archaic laws and over-regulation. Most pernicious is regulation that directly limits competition by saying to potential competitors:

> You shall not engage in any new activity or you may engage in your present business only in a single, limited geographic area.

As was most recently recognized by Congress in connection with airline deregulation, this anticompetitive regulation is also saying:

> You, the public, are limited in your choice of alternatives; you cannot obtain the full benefits of competition.

Notwithstanding these basic precepts, an entire structure of anticompetitive laws and regulations deprives United States commercial banks of freedom to compete and thereby denies to users of bank services the benefits of competition. Virtually alone among all industries, U.S. banks are severely restricted as to: 1) the types of services they can perform; 2) the locations where even these limited services can be offered, at best a single state and in some cases a single city block; and 3) the prices at which services can be offered. These limitations do not apply to commercial banks' competitors.

As a direct result of this anticompetitive scheme of regulation, a revolution is taking place in the financial services market. I will deal separately with the two most important aspects of this revolution: the emergence of large domestic financial service corporations, unrestricted by banking laws and regulations, and the relative decline of U.S. banks in the worldwide financial market.

Structure of the industry

While banks, large and small, have been prohibited by law from providing a wide range of financial services, the public has been increasingly demanding those services. As a result, large financial enterprises that are not banks have moved in to meet the demand and they are doing so in New York, Salt Lake City, Milwaukee and every other city in the country. That is exactly the way a free market should work, except for one thing: The reason banks are not meeting the demand is not through lack of skill, initiative and desire; it is due to government regulation. In effect, a new financial services market is rapidly taking shape, comprised of two types of competitors: unregulated companies able to provide virtually every financial service demanded by the public, and regulated banks able to provide only limited financial services.

Even as to that business which banks are permitted to conduct, nonbanks, free from the restraints to which banks are subject, have been able to seize a major portion of bank business. These companies offer most of the same financial services as banks, but, unfettered by bank charters, they can offer more services, more competitive services and services to a far wider range of customers. They have steadily increased their share of U.S. financial assets at the expense of commercial banks.

For example, Merrill Lynch describes itself in its 1980 annual report as a "diversified financial services company" with offices in 49 states. The accuracy of this statement is demonstrated by the fact that the largest single component of its revenues is interest. The services it offers—on a nationwide and worldwide basis—include the equivalent of deposits with check-writing privileges; hundreds of millions of dollars of domestic loans; credit card services; brokerage; underwriting; a full range of all other investment banking services; all forms of insurance; all forms of real estate services; and a complete range of international banking services. Domestic banks can offer only a fraction of these services and on a far more limited geographic basis.

As the general level of interest rates began a steady climb in the mid-1970s, the public increasingly demanded a market rate of return on its deposits. However, government regulations prohibited banks from providing this rate of return.

The phenomenal success of Merrill Lynch's cash management account program reflects its ability to offer services to the individual and businessman far beyond the scope of any bank. The cash management account combines a checking account, bearing interest at a market rate, with loan services, credit card and brokerage services.

Other examples abound. Gulf+Western, one of the nation's largest conglomerates, is also one of the largest consumer finance companies, commercial lenders and factors. Gulf+Western also now engages in full-scale consumer banking through a bank subsidiary in California. The bank regulators were compelled to permit Gulf+Western to acquire a bank that agreed not to make commercial loans. The same result would presumably occur if Gulf+Western acquired retail banks in the 49 other states.

While these bank subsidiaries could not make commercial loans, this should be of little or no hindrance to Gulf+Western, which makes commercial loans through its other subsidiaries.

Perhaps the most dramatic illustration of the growth of nonbank competitors during the past several years has been the development of the money market funds by the major investment banking companies. As the general level of interest rates began a steady climb in the mid-1970s, the public increasingly demanded a market rate of return on its deposits. However, government regulations prohibited banks from providing this rate of return. The result was inevitable. A vehicle was created known as a money market fund which provided a market rate of return and, in addition, check-writing privileges. From a base of less than $5 billion in 1977, the money market funds today exceed $110 billion. The money market funds of Merrill Lynch alone, some $22 billion, exceed the domestic deposits of all but one or two banks. The solution to this regulatory disparity is to authorize banks to offer market rates of interest to consumers.

A new phase begins

The financial services revolution has recently entered an accelerated phase with the acquisition of major investment banking concerns by two of the nation's largest nonbanking financial institutions, which are equal in size to the very largest U.S. banks and provide most of a bank's services. The two combined institutions, American Express-Shearson Loeb Rhoades and Prudential-Bache, illustrate with graphic clarity the enormous size, power and geographic scope of the nonbanking financial service companies. The two acquisitions also illustrate the regulatory disparity between banks and other financial institutions.

The Prudential Life Insurance Company, the world's largest life insurance company, has assets of approximately $60 billion, which makes it larger than all but three U.S. banks. Based on domestic assets alone, it is probably larger than any U.S. bank. Prudential has over $400 billion of life insurance in force and manages substantial investments for others. Prudential could declare in its 1979 annual report that it served over 50 million people and that it has "evolved into a truly multi-lines international organization, large and diverse enough to innovate and pioneer in ways that few other financial institutions can."

The Bache transaction makes this statement even truer. Bache is the sixth largest investment banking concern with 193 offices nationwide. Bache's sales force of 2,800 will join the Prudential sales force of 25,000. Bache's money market funds hold $2.9 billion of deposits.

American Express has approximately $20 billion in assets. Its $2.16 billion in equity would rank fourth among U.S. banks and its 1980 income would likewise rank fourth. American Express could boast in its 1980 annual report that its global banking coverage exceeds all but three U.S. banks. In acquiring Shearson, American Express will add the second largest investment banking concern with some 250 offices coast to coast and a money market fund of over $2 billion. In addition, what has been little reported in the press is that Shearson, and now American Express, have contracted to purchase The Boston Company, which owns a $228-million-asset bank in Boston.

The adverse implications of the competitive position of commercial banks under the present regulatory structure become even more serious in the context of potential changes in the financial services industry. A major development in banking during the 1980s is quite likely to be in the area of communications. It is widely anticipated that banking will increasingly be done through sophisticated communications equipment located in the home and office. Gulf+Western and American Express are among the leaders in communications through subsidiaries in cable television and electronics. As the highly respected *Economist* recently predicted: "With technology acting as a catalyst, the banking business can be expected to draw in any number of new participants, ranging from department stores to retail chains, from oil, television and telephone companies to data-processing agencies."

The adverse implications of the competitive position of commercial banks under the present regulatory structure become even more serious in the context of potential changes in the financial services industry.

Perhaps the best way I can illustrate the significance of what this revolution means is to compare the services that a U.S. bank can offer with the services offered by these new financial services corporations.

A U.S. bank can take domestic deposits. But Merrill Lynch can take the equivalent of deposits through its cash management accounts and money market funds, and American Express through its travelers checks and, after the proposed acquisitions of Shearson and The Boston Company, through Shearson's money market fund and The Boston Company's retail bank subsidiary. And Merrill Lynch and American Express have access to far wider markets than a U.S. bank in obtaining funds through offices in all 50 states. In contrast, a U.S. bank is limited to taking deposits through offices in one state. Merrill Lynch and American Express can pay a market rate of interest even on accounts with check-writing privileges, while no U.S. bank can directly pay any interest on business checking accounts and cannot pay a market rate of interest on any consumer account.

A U.S. bank can make domestic loans, but so can Merrill Lynch and American Express.

A U.S. bank can engage in international banking. So can and do Merrill Lynch and American Express. Indeed, American Express's international banking operations are considerably larger than those of most U.S. banks.

A U.S. bank cannot provide brokerage services, because the restraints are such as to make them unfeasible. Merrill Lynch provides brokerage services in 49 states. American Express will soon acquire this capacity through Shearson.

Twenty-five years ago, U.S. banks held 50 percent of the assets of the world's 100 largest banks; today that percentage has declined to 15 percent.

A U.S. bank cannot provide anything approaching full insurance services. Merrill Lynch and American Express are major forces in the insurance industry.

A U.S. bank cannot underwrite revenue bonds, much less corporate securities. Merrill Lynch is the largest underwriter in the country; American Express will be one of the largest upon its acquisition of Shearson.

A U.S. bank can offer only limited real estate services. Merrill Lynch is one of this country's major providers of such services.

More broadly, a U.S. bank cannot embark on a meaningful expansion of services without an expensive formal application process which frequently involves prolonged delay. The standards applied are far more restrictive than the antitrust laws. Merrill Lynch and American Express do not have to worry about any such regulatory approval. They just go ahead and consummate their acquisitions—and are subject only to normal antitrust standards.

The growing position of foreign banks

The second aspect of the financial revolution is the relative decline of U.S. banks in the worldwide financial market. In recent years the prestige and power of American commercial banks have dropped precipitously as compared with foreign banks. Twenty-five years ago, U.S. banks held 50 percent of the assets of the world's 100 largest banks; today that percentage has declined to 15 percent. In 1956, 25 of the 50 largest banks in the world were U.S. banks; today only six U.S. banks rank in the top 50. In 1970 my bank, Irving Trust, was the 52nd largest in the world; today, although we have trebled in size and maintained our relative position among U.S. banks, we are not even in the top 100 banks on a worldwide basis. This relative decline largely reflects the degree to which laws and regulations hamper the ability of U.S. banks to compete with foreign banks which do not confront similar restrictions.

While the International Banking Act of 1978 made the U.S. regulatory structure for foreign banks more consistent with that for U.S. banks, the far less strict regulatory environment in these foreign banks' home countries has been an important factor in their major penetration of the U.S. markets. Foreign banks have been able to capture about 40 percent of the commercial and industrial loans made in New York and 13 percent of all such loans made in the United States. These percentages do not include the substantial and increasing amount of loans to U.S. companies booked at the foreign offices of foreign banks.

Of perhaps even more significance is the rapid rate of penetration. Between June 30, 1978, and June 30, 1980, alone, foreign bank commercial and industrial loans in the United States increased by 80 percent, while U.S. bank commercial and industrial loans increased by only 2 percent. As the chairman of one of the world's major foreign banks recently stated in an interview with United Press International:

> "What we [foreign banks] can do is astounding to American banks. What American banks cannot do is astounding to almost every other bank in the world."

A continuation of this deterioration in the competitive position of U.S. banks could have a negative impact on our national interest. It will result in an increased dependence by U.S. business on foreign banks as sources of credit, increase the economic vulnerability of the U.S. to foreign interests, and impair the ability of the U.S. government to implement national policy.

Solutions to the problem

Having described at length the problem, let me turn to what is, in effect, a straightforward solution. We are not asking that U.S. banks be given any special advantages, nor are we asking that our competitors be subjected to new regulation. We are merely asking that U.S. banks be given the same opportunity to compete as their competitors, that regulatory restraints virtually without parallel in any other sector of the American economy be removed.

Congress could accomplish this objective without passing a single new law; without paying a penny in subsidies; and without initiating another government program. All Congress would have to do is to amend a small number of laws, several of which go back to the Depression and even earlier, and which do not respond to the economic conditions and circumstances of today. We therefore recommend removal of the competitive imbalances resulting from:

We are merely asking that U.S. banks be given the same opportunity to compete as their competitors, that regulatory restraints virtually without parallel in any other sector of the American economy be removed.

> The Glass-Steagall Act, adopted in 1933, which prevents banks from providing many securities services utilized by their customers.
>
> The McFadden Act, adopted in 1927, and the Douglas Amendment, adopted in 1956, which prohibit U.S. commercial banks, but not their competitors, from providing banking services across state lines.
>
> Section 4(c) (8) of the Bank Holding Company Act, adopted in 1956, which has been interpreted to prevent bank holding companies from providing the range of financial services offered by their nonbank competitors.
>
> Regulation Q, adopted under a 1913 statute, which prevents banks from paying realistic interest rates on consumer deposits.
>
> Regulation D, adopted under a 1913 statute, which imposes on U.S. banks reserve costs not incurred by foreign banks and other competitors.

We strongly believe that the time for remedial action is now. Congress should not reduce the debate to whether commercial banks should or should not engage in one or another narrowly defined activity. At home, American consumers will not wait for these issues to be sorted out. On a worldwide basis, the loss of American banks' market share has been so steep that, in our opinion, immediate action is required merely to arrest this trend.

These hearings have focused in large part on the unfortunate results that inevitably occur when financial institutions are prohibited from being competitive by laws and regulations. As Secretary Regan testified: "The current problems facing thrift institutions are largely the result of prior government attempts to structure an industry by statute in ways that are not economically feasible." If in the future you do not want to have commercial banks requesting action to avoid problems similar to those confronting the thrift industry today —but with consequences many times greater—then expeditious action is required.

The limitations on commercial banks may have been justifiable in times when financial services were tightly compartmentalized and when banks served primarily local markets. They may have been appropriate when insurance companies engaged primarily in insurance and not heavily in bank-type lending and investment banking; when investment bankers were limited to investment banking and did not take the equivalent of deposits, and engage in lending, insurance and real estate services; when no company, bank or nonbank, even approached the wide variety of services offered and to be offered by American Express; when foreign-bank penetration of U.S. markets was minimal. These limitations clearly are no longer appropriate.

Analyzing the objections

The two principal objections that have been raised against deregulation are undue concentration of economic power and conflicts of interest. On analysis, each proves to be unfounded.

Any undue concentration is prevented by the highly competitive structure of the market for financial services. A commercial bank faces competition from the giant insurance companies such as Prudential and Aetna; from the huge financial services companies such as American Express and Merrill Lynch; from the retail and industrial-based companies with substantial financial operations such as Sears, RCA and Gulf + Western; from the numerous foreign banks, most of them larger than their U.S. counterparts, which compete in the United States; from the numerous alternative sources of funding such as the commercial paper market; and, finally, from 14,000 other U.S. banks.

Indeed, relief from anticompetitive regulation will undoubtedly result in deconcentration rather than concentration. For example, the securities industry is highly concentrated. Almost all the corporate and municipal revenue underwriting is managed by a handful of investment banking firms. A similar situation exists for brokerage services. No bank even begins to approach the leading position in the banking industry that Merrill Lynch has secured in the securities industry.

Acquisitions by commercial banks are fully subject to the nation's antitrust laws and, in addition, require the prior approval of not only federal but, in most cases, state bank regulatory agencies. We find it difficult to believe, especially in light of the emergence of large nonbank financial services companies, that the antitrust laws are inadequate only with respect to the banking industry. This is particularly true since the banking industry, unlike most others, is in any event subject to direct regulatory oversight with respect to its expansion activities. Finally, even if a desirable degree of deregulation is accomplished, the result will only be to permit banks to compete in the increasingly homogeneous financial service industry. There is no suggestion that financial services be combined with commerce and industry.

The second area of concern—conflicts of interest—is a red herring. The conflicts are not serious to begin with, and in any event not so serious as to have required similar anticompetitive regulations for other financial service companies.

For example, it is alleged that Glass-Steagall is necessary to protect against the conflicts that would arise from a combination of underwriting and deposit-taking. Is this situation any different for a major insurance company that annually collects billions of dollars of premiums from individuals—premiums that it must prudently invest to insure that the families of the insured are protected? Yet, a major insurance company is permitted to acquire one of the largest investment banking concerns in the country. Likewise, a giant financial services company annually collects billions of dollars of deposit equivalents in the form of funds entrusted for payment of travelers checks. Yet this company, too, can buy a major investment banking concern. Major investment banking concerns have substantial funds equivalent to deposits entrusted to them in the form of money market funds and cash management accounts. Yet, they have for years engaged in a full array of securities activities.

The revolution in the financial services industry is irreversible. It cannot be halted or even rolled back because it is an inevitable response to the demands of the public, the conditions of the markets and the pace of technological development.

Gentlemen, the revolution in the financial services industry is irreversible. It cannot be halted or even rolled back because it is an inevitable response to the demands of the public, the conditions of the markets and the pace of technological development.

The crucial question before us is whether this revolution will result in healthy, progressive competition and a sound banking system or, in the alternative, an uncompetitive system dominated by a handful of large nonbank financial service companies and foreign banks, a progressively deteriorating U.S. banking system and a loss of U.S. economic and political power and prestige. The answer to this question depends upon whether Congress will take the actions necessary to relieve banks from a system of regulation that is archaic, anticompetitive and, above all, unresponsive to the demands of the public and current economic conditions. If Congress will take these actions, we firmly believe that the results will be better service to the American public, a stronger U.S. financial system and a more meaningful presence in the worldwide financial market.

The CHAIRMAN. Thank you, Mr. Lee.

Mr. Hefner.

PAUL HEFNER, VICE PRESIDENT, FIRST INTERSTATE BANCORP, LOS ANGELES, CALIF., CHAIRMAN OF THE BOARD, ELECTRONIC FUNDS TRANSFER ASSOCIATION

Mr. HEFNER. Thank you, Mr. Chairman, Senator Hecht. Thank you for your kind invitation to appear here this morning.

My name is Paul Hefner, vice president and director of electronic banking services at First Interstate Bancorp, a multistate, multibank holding company headquartered in Los Angeles.

I am also chairman of the board of the Electronic Funds Transfer Association. It is in that capacity that I appear here today.

The EFT Association is a multiindustry organization representing the interests of all participants in the EFT industry. That includes depository institutions of all types, nondepository, providing of financial services, retailers, equipment and software manufacturers, data processors, and telecommunications providers.

Our role as a forum for the EFT ideas of every commercial group usually precludes our promoting any one group's legislative proposal, which at any given point in time may be at odds with interests of other members of our group.

When the EFT Association adopts a public position, we do so only after taking all steps necessary to insure that it represents a broad consensus within the AFT community that I have just described.

My testimony this morning is divided into three parts: First, a review of electronic funds transfer as we perceive it today; second, a discussion of current legislative issues impacting EFT development; and third, a specific proposal for EFT legislation.

It is my intention to summarize my prepared written testimony, which I assume, Mr. Chairman, will be entered into the record.

The CHAIRMAN. Yes; it will be.

Mr. HEFNER. Thank you.

EFT FUNCTIONS

Electronic funds transfer is not a new banking function. Rather, it is a new delivery mechanism, another way of delivering financial products rather than through the use of paper.

Today's most visible symbol of electronic funds transfer is the ubiquitous automated teller machine, more commonly referred to as an ATM or 24-hour banking machine. In just a decade the popularity and acceptance of ATM's has exploded. Consumers perform billions of ATM transactions today at approximately 38,000 ATM's in this country.

Two years ago, in testimony before this committee, the EFT Association noted ATM usage was evolving into a new phase called interchange. ATM interchange occurs when the customer of one financial service provider accesses his or her account through the ATM of another.

In the last 2 years, the development of ATM interchange networks has reached extraordinary proportions. More than half a dozen national networks have been organized, and hundreds of local and regional ATM interchange networks have been established.

Through the interconnection of these networks, consumers will have the ability to withdraw cash or its equivalent whenever and wherever they may be.

Significant EFT developments have also been taking place in many other areas of the payments system. Frankly, a quiet revolution is occurring in the automated clearinghouse system.

The time has clearly come for this ACH system to cut the apron strings with the Federal Reserve System and stand on its own. The Fed's role as the dominant operator and provider of ACH services is ending.

Private sector alternatives are beginning to emerge, and we could soon see an accelerated level of preauthorized payments, including direct deposit of payroll and automated bill payments.

In another area, retail point of sale services promised during the 1960's and 1970's may in fact become a reality in the 1980's. The so-called POS services permit individuals to use the same plastic cards that they use at their ATM's to purchase goods and services at retail locations.

Helping to promote the introduction of POS services are the growth of ATM networks themselves, a broader consumer acceptance of these kinds of payments with debit cards, and a new spirit of cooperation between the banking and retailing industry.

Perhaps the biggest financial service surprise of the 1980's may very well be the dramatic developments in the home financial services field. These services permit individuals to pay bills, check their account balances, transfer funds, make investments, and perform a wide variety of financial services from computer terminals in their homes and in their offices.

Home and office financial service systems will permit personalized service on a level never before possible, including education about new and more helpful types of financial services.

SUGGEST CHANGES TO SIMPLIFY THE EFT ACT

Turning to legislative issues, we noted that in its recent testimony before this committee the American Bankers Association suggested a number of specific changes that Congress should make to simplify the EFT Act.

Some of the more important suggestions focused on giving the Federal Reserve Board greater authority to modify EFT statutory requirements, reducing the amount of required initial disclosures to truly important information that consumers will really use and providing a negligence standard for consumer liability in lieu of the current three-tiered liability scheme.

The EFTA supports ABA's recommendation that Congress review and simplify the EFT Act. We suggest, however, that if you do rewrite this act, that your efforts be oriented toward setting overall goals rather than proscribing details which may inhibit technological innovation.

In an area such as EFT, where the pace of technological advancement is rapid, Congress should focus, we believe, on a clear expression of the type of any consumer protection it intends to provide and then authorize an agency such as the Federal Reserve Board to set and amend specific rules as quickly as changing circumstances warrant.

The marketplace experience with EFT, as with other financial services, indicates that legislative inertia cannot arrest the momentum of concepts that are in tune with the times. Interstate EFT operations exist today and are growing despite legislative hurdles and the absence of modern day congressional input.

We add our voice to others, urging Congress to directly address the geographical expansion of banking and the new realities of the financial service delivery.

ELIMINATE RESTRICTIONS ON DEPLOYMENT OF EFT TERMINALS

In testimony before this committee, the Consumer Bankers Association recommended the elimination of all restrictions on the deployment of EFT terminals as a first step in eradicating all geographic restrictions on providing consumer financial services.

The EFTA has not taken a position at this time on this issue. Clearly, many of our members would be pleased to see this happen. Others, frankly, are not so certain.

And, the EFTA can only support those proposals that have the broadest multi-industry backing. We do believe that broad support exists for a proposal that we would call the EFT Interchange Act.

The complete details of our proposal for Federal legislation are included in my formal written testimony. Let me summarize it for you.

The proposal would cut through the ambiguities that currently characterize the law related to EFT interchange and clearly authorize every depository institution to permit its depositors to use any ATM or point of sale terminal anywhere if that terminal has been established and is being operated in accordance with applicable laws.

Our proposal would authorize the withdrawal of cash or its equivalent, such as traveler's checks or scrip that is redeemed for merchandise. It would also permit the making of payments and the acquisition of balance inquiries by the consumer.

Other functions, such as deposit taking, which may be authorized in some jurisdictions, would not be precluded by this proposal.

Now, only depository institutions and their customers are addressed in our proposal. Nondepository institutions are not included because they are not prohibited from offering these types of services and, we believe, would not and should not be limited should this proposal be enacted.

Under our proposal States would retain the powers that they currently have to regulate the deployment of EFT terminals. If a terminal has been deployed in accordance with whatever Federal or State law might be applicable to its deployment, then our proposal would merely authorize its use in any local, regional, national, or international interchange.

We believe this legislative proposal recognizes the legitimacy of the many EFT interstate interchange systems that already exist today. By enunciating a uniform national policy in favor of such interchange, Congress would not foreclose any changes in the present geographic restrictions on interstate financial service delivery. If enacted, this proposal would create legal certainty where there is now an environment of confusion and ambiguity.

Consumers today are enjoying significant benefits from EFT systems, and they are eager to have more. It is doubtful that we will become either a cashless or checkless society in your lifetime or mine. Throughout history, as each new payment mechanism entered the marketplace, it did not replace the existing one. Instead, all methods of payments have been layered one on top of the other. Those that have been the most used at any one point in time have been the payment mechanisms that the users, the consumers, found to be the most convenient. We think that will apply to electronic funds transfers as well.

Mr. Chairman, on behalf of the EFTA, the Electronic Funds Transfer Association, I would like to express our appreciation for this opportunity to present our views to you this morning.

[The complete statement follows:]

STATEMENT OF PAUL HEFNER
on behalf of
THE ELECTRONIC FUNDS TRANSFER ASSOCIATION

Mr. Chairman and members of the Committee, my name is Paul Hefner. I am Vice President and Director of Electronic Banking at First Interstate Bancorp, a multi-state bank holding company, headquartered in Los Angeles, with 22 banks in 11 western states. I am also the Chairman of the Board of Directors of the Electronic Funds Transfer Association, in which capacity I am testifying today. I am accompanied by Henry Polmer, a partner in the law firm of Bell, Boyd & Lloyd. Mr. Polmer, who was the Deputy General Counsel of the National Commission on Electronic Fund Transfers, is the General Counsel of the EFT Association.

The Electronic Funds Transfer Association was established as a multi-industry EFT trade association in 1977, just as the Congressionally created National EFT Commission was ending. Since that time, the EFT Association has represented the interests of depository institutions of all types, non-depository providers of financial services, retailers, brokerages, insurance companies, equipment and software manufacturers, data processors, telecommunications providers and other participants in the electronic funds transfer industry. The EFT Association's concerns span a spectrum from government affairs to the development of technical industry standards.

We are particularly pleased to appear before this Committee to express the views of our broad-based membership in a very narrow yet very important area of banking -- namely EFT. Our role as a forum for the EFT ideas of every commercial group usually precludes our promoting any one group's legislative proposals which may be at odds with the interests of other member groups. Diversity in the EFT Association is not merely a mixture of small institutions and large ones. Diversity to us means institutions from a multiplicity of industries that are all involved as users or suppliers of the technologies that make EFT possible. Our forte is the gathering and exchange of information and most importantly the analysis of EFT issues and their alternative solutions. When the EFT Association takes a public position, we do so only after taking all necessary steps to ensure that it represents a broad consensus of opinion within the EFT community.

In keeping with the nature of our Association, you will find three elements in my statement. First, a description of electronic funds transfer as we perceive it today. Second, a brief discussion of current legislative issues that impact the development of EFT, and, finally, a specific proposal for EFT legislation.

Electronic funds transfer or EFT began creeping into the banking lexicon in the early 1970's, when futurists were simultaneously fascinated and alarmed by predictions of the imminent transformation of America into a cashless, checkless society. The demise of dollar bills and paper checks did not occur, but the idea of additional electronic payment media has taken hold.

EFT is not a new banking function; rather, it is a new delivery mechanism. EFT offers the ability to perform electronically the traditional functions of a payment system more quickly and conveniently than ever before and the means to deliver new financial products and services to meet the market demands of consumers and businesses. In addition, EFT technology should ultimately reduce significantly the escalating costs of providing financial services. Costs are saved when less paper flows through the system, when fewer checks go through the mails, when the need for new branch banks is diminished, when float is controlled or reduced, and when human labor can be directed to more productive tasks than receiving deposits and paying checks.

Today's ubiquitous symbol of EFT is the automated teller machine or ATM. A decade ago there existed a handful of underutilized ATMs. Now consumers use ATMs to perform billions of transactions per year. There are approximately 38,000 ATMs deployed in the United States -- an average of one ATM for every 8,800 Americans. The investment of financial institutions in ATM terminals alone has reached a billion dollars.

Two years ago in testimony before this committee we noted that ATM usage was evolving into a new phase called interchange. Financial institutions that owned ATMs were increasingly making those machines available through networks to customers of other financial institutions in return for transaction fees. This phenomenon has reached extraordinary proportions. Local interchange networks exist in our cities and larger networks have interconnected ATMs throughout most of our states. Now broader ATM networks are extending the convenience of ATM withdrawals within multi-state regions and national ATM networks are just beginning to provide ATM-based cash withdrawals for consumers wherever they travel in the United States.

The rapid growth of these shared ATM networks is the result of many factors. ATMs are popular because they are convenient. A consumer may perform basic financial transactions wherever and whenever it is convenient and efficient. The value of a consumer's debit card is directly related to the number of ATMs available to him and the locations of those machines. Financial institutions, of course, want to enhance the value of these cards, and a network in which institutions interconnect their ATMs and permit the customers of other institutions to use them on a transaction fee basis does exactly this.

Economics alone could have led to several varieties of ATM networks. For example, some financial institutions might have elected to deploy many of their own ATMs over non-traditional geographic areas and to make them available to the customers of other institutions in return for transaction fees. But the law has apparently foreclosed this option, at least for national banks and state member banks. The McFadden Act has been interpreted by the courts to apply to ATMs and to limit these banks to deploying their own ATMs only where they can build brick and mortar branches.

Thus, the market momentum for exponential ATM expansion coupled with the McFadden Act's limitations on proprietary networks by national banks has created a plethora of local, regional and now national ATM interchange networks, many of which interconnect ATM's across state lines and permit consumers to withdraw cash wherever they travel. Although these interchange networks have already established ATM-based cash withdrawals as a consumer service that is crossing nearly every state line, ambiguities lurk in many state laws that could cause expensive problems, inequities and service interruptions to some consumers unless Congress addresses this situation promptly. I shall return to this subject to discuss the EFT Association's recommendation later in my testimony.

Significant EFT developments have been taking place in many areas of the payments system besides ATMs, and I would be remiss if I did not discuss at least three: preauthorized payments, retail point-of-sale (POS) and home financial services.

A quiet revolution is occurring in the automated clearing house (ACH) system. In its almost ten years of operational existence, the ACH system has grown to a level of activity that is roughly one percent of the current check volume. (Total ACH volume in 1982 was 351,435,758 preauthorized credits and debits; total check volume 1982 was estimated at approximately 35,000,000,000.) Initially, government credits particularly Social Security payments, represented almost the entire ACH volume. Today, the federal government's slice of the

ACH activity pie is only a sliver more than half. (Total government ACH credits in 1982 were 176,821,892 - 50.3% of the total. Private ACH credits and debits in 1982 totaled 174,613,862 - 49.7% of the total.)

The next few years could bring an accelerated level of preauthorized payments, as past efforts of this Committee, private industry, and the Federal Reserve System now begin to help the ACH system establish its independence. After years of a comfortable and nurturing relationship with the Federal Reserve System, the National Automated Clearing House Association is seeking a private-sector alternative to the Fed-run ACH system. This is helped as the Federal Reserve moves toward prices that reflect the actual costs of its services, a policy decision initiated by this Committee.

In the next few years, we could see several, competing, private-sector, ACH-like systems, offering an array of attractive, well marketed, preauthorized payment services. While these networks may operate apart from the Federal Reserve System, except for settlement purposes, it is logical to expect that the current ACH system may still be used for the "delivery" of many preauthorized payments.

The ACH system is as strong and healthy as it is today because of the Federal Reserve System's support, but the time has clearly come for the ACH system to cut the apron-strings and stand on its own. If the Federal Reserve has a role in the future of preauthorized payments, it may be as a partner, not as the sole or dominant ACH provider and operator.

The retail point-of-sale service, promised during the 1960's and 1970's to be the keystones of the cashless and checkless society, may become a reality in the 1980's. These POS services permit individuals to use the same plastic cards they use at their automated tellers to purchase goods and services at retail locations. The dramatic growth of ATM networks is only one reason for the very high expectations for POS services in the immediate future. POS services are rapidly developing for four principle reasons:

1. Much of the cost of establishing POS EFT networks has now been justified and is being absorbed by the implementation of ATM networks.

2. Consumer acceptance of the debit card is much greater today than it ever was. Initial use of the debit card in a POS EFT environment may continue to be for cash access, but can be expected to eventually evolve into an independent payment mechanism, primarily displacing checks in the marketplace.

3. Bankers are listening carefully to retailers' ideas on how a POS EFT system should operate. Bankers are recognizing that retailers will be their partners in the development of POS EFT systems.

4. Retailers are beginning to abandon their negative reaction to EFT. Rather, many leading retailers are starting to recognize the considerable benefits that POS EFT systems can bring them including increased productivity in store operations, improved cash management, and improvements in the control of losses from fraudulent transactions.

The biggest financial service surprise of the 1980's may very well be the dramatic developmental strides being made in the home financial services field. These home services permit individuals to pay bills, check their account balances, transfer funds, make investments, and perform a wide variety of financial services from computer terminals in their homes and offices.

Several services have already been announced. Some are being offered solely by financial institutions and others are being offered in conjunction with general information providers. Some technological innovations, such as the development of less expensive and more powerful personal computers, are still needed before home financial services can reach their full potential, but a great deal of change can be expected in the years ahead. This product, however, is not waiting for new technology. For example, a near-term beneficiary of home financial service product development may well be the professional (i.e., doctor, lawyer, accountant) and the small business with a gross annual income under $5 million. This market has two important factors already in its favor. Most already have a small computer or terminal with communications capabilities and they are a market that traditionally opts for time-saving, convenient services. It is also clear that home financial services will not be marketed in a vacuum. They will be part of an array of information and entertainment services that will be delivered via a variety of telecommunications options, such as telephone, satellite, microwave, and cable-television systems.

One important aspect of providing financial services via personalized terminals will be the ability of the financial service provider to educate consumers about new and more complex types of financial services. Home financial service systems will permit personalized service on a level never before possible. When viewed as a mechanism to educate as well as transfer and manage funds, these home financial services should satisfy the individual consumer, who could be demanding (and quite likely receiving) the same level of financial services that a medium-sized corporation receives today.

All of these and other very promising EFT developments are occurring in a legal and regulatory environment long due for a major overhaul. Two of the current legislative topics that are most relevant to EFT developments are changes in the Electronic Funds Transfer Act of 1978 and the general debate on how and when to remove the barriers to nationwide financial service delivery by all types of institutions.

The EFT Act and the Federal Reserve Board's Regulation E which implements it have always received close scrutiny from this association. The EFT Act was intended to provide a basic framework establishing the rights, liabilities and responsibilities of participants in retail EFT systems. It was also intended to provide consumer protection in regard to EFT. No doubt, the Act was drafted with the most laudable intentions. However, as appears to be the case regarding a great deal of consumer protection legislation, the actual consumer protection which many of its provisions afford is low relative to the costs, in terms of dollars to comply and programs denied to consumers because they cannot feasibly be brought into compliance with the Act.

The EFT Act suffers from several faults. First, it assumed that massive disclosures protect consumers. The available evidence indicates that consumers do not read these disclosures. One bank added a special paragraph to 100 of its 130,000 EFT disclosure pamphlets inviting readers to send in for a free $10. No one applied. Second, the Act prescribed very specific consumer protection requirements without appreciating how each would affect various types of existing EFT systems and whether these requirements would be feasible in connection with other systems that advancing technology would bring to the marketplace. For example, the printed documentation which the Act requires is sensible in connection with ATM transactions and was in fact routinely being offered by financial institutions before the Act. However, a printed receipt makes no sense in connection with home terminals, and if the Federal Reserve had not interpreted the EFT Act liberally, the cost of adding a printer to every home terminal would have delayed or even prevented the birth of home financial services.

In its recent testimony before this Committee, the American Bankers Association suggested a number of specific changes that Congress should make to simplify the EFT Act. Several of those changes have previously been recommended by this association. Some of the most important ones include the following:

- give the Federal Reserve Board greater discretion in modifying statutory requirements when it demonstrates that the compliance costs outweigh the consumer protections provided;
- reduce the amount of required initial disclosures to truly important information; and
- provide a negligence standard for consumer liability in lieu of the current three tier liability scheme.

We support the recommendation of the ABA that Congress review and simplify the Electronic Fund Transfers Act, and we suggest, if you rewrite this Act, that your efforts be oriented toward setting overall goals, rather than prescribing details, which may inhibit technological innovation.

In an area, such as EFT, where the pace of technological advancement is rapid, Congress should not impede progress with detailed consumer protection legislation that tomorrow may be entirely infeasible as well as unnecessary. Where consumer protections are deemed necessary, Congress should clearly express the type of protection it intends to provide and authorize an agency, such as the Federal Reserve Board, to promulgate and amend specific rules as quickly as changing circumstances warrant. Regarding the documentation requirements of the EFT Act, for example, consumers and the EFT industry would have been better served if Congress had expressed its intention that consumers have a right to obtain prompt documentation of each electronic funds transfer and then authorized the Federal Reserve to determine the types and frequency of documentation necessary in various situations. Fortunately, Congress has the ability to amend the EFT Act, and this Committee has taken the initiative to review the performance of the Act to date.

As this Committee is well aware, the substantive and political issues surrounding the removal of the geographic limitatons imposed by the McFadden Act and the Douglas Amendment to the Bank Holding Company Act are complex. EFT development is one part of the equation that Congress must balance in this area.

The marketplace experience with EFT, as with other financial services, indicates that legislative inertia cannot arrest the momentum of concepts in tune with the times. The intricacies of the banking laws offer numerous opportunities for those with sufficient resources and desire to chip away at apparent restrictions. Interstate EFT operations exist today and are growing despite legislative hurdles and the absence of modern-day Congressional input. In our opinion, it would be wise for Congress to directly address the geographic expansion of banking and the new realities of financial service delivery.

In its well-structured testimony before this Committee, the Consumer Bankers Association has recommended the elimination of all restrictions on the deployment of electronic terminals as a first step in eradicating all geographic restrictions on providing consumer financial services. The EFT Association has not taken a position as to whether this is the best first step on the road to a new banking environment. Removing all EFT terminal restrictions would permit banks to deploy their own ATM systems throughout the United States. Many of our members would be pleased to see this happen; others are not so certain. In any event, such an action would create a new environment, and, as I indicated earlier, our multi-industry association is keen to debate all legislative proposals that affect EFT but can support only those with the broadest multi-industry backing.

A proposal with such broad support is a proposed bill we have been quietly circulating, which we have identified as the "Electronic Funds Transfer Interchange Act of 1983," the full text of which is appended to this testimony as Attachment A. This bill would not change the existing environment in which ATM networks have been created on an interchange basis. It would merely remove the legal uncertainty that exists in some areas because of some ambiguous state laws that were generally enacted before EFT interchange existed. This bill would cut through the ambiguities of state law and clearly authorize every depository institution to permit its depositors to use, on a transaction fee basis, any ATMs or POS terminals anywhere that have been established and are being operated in accordance with applicable laws.

Most states have no laws which directly address the concept of an EFT interchange. However, the laws of some states which generally prohibit unauthorized banking could be construed to impede the use of ATMs and POS terminals by the customers of out-of-state depository institutions. These laws -- put on the books before the idea of EFT existed -- are unclear about what they intend to prohibit. While we do not believe they could reasonably be applied to preclude EFT interchanges, financial institutions which are investing heavily in such interchanges can never be certain that they will not some day face a lawsuit to halt their activities based on a fuzzy interpretation of an archaic law.

Although the laws of many states expressly address EFT, the application of some of these EFT statutes to the interstate interchange concept is unclear. Montana has an ambiguous EFT law that could be interpreted to forbid any interstate interchange. Minnesota generally forbids the use of off-premise ATMs by the customers of out-of-state institutions but permits the use of on-premise ATMs. Wisconsin permits institutions from out-of-state to share ATMs of "like" institutions in Wisconsin. Whether this Wisconsin law would prohibit the customers of an out-of-state bank from using the ATMs of a Wisconsin S&L is unclear.

Some states such as Florida and Illinois have removed or are in the midst of removing their interchange restrictions in ambiguous ways that may raise as many issues as they law to rest.

The EFT Association believes that the overwhelming majority of the states have no intention of restricting interstate EFT interchanges in which the customers of out-of-state institutions use terminals properly deployed within a state to access their out-of-state credit or asset accounts for the purpose of withdrawing funds or making payments. Moreover, we believe that such restrictions would be held unconstitutional if they were to be imposed. Nonetheless, the legal costs of fighting such prohibitions in the courts could be significant, and the present uncertain legal environment has a chilling effect on the development of financial services to better serve the American public. For these reasons the EFT Association proposes the Electronic Funds Transfer Interchange Act of 1983 and urges its immediate consideration by this Committee. The substantive provisions of the proposed bill provide as follows:

> Section 4. Notwithstanding any limitations on its own authority to establish, own, operate or maintain electronic terminals, a depository institution may, without regard for terminal location, permit its depositors to use any electronic terminal for the following purposes:
>
> (a) withdrawing cash from accounts maintained at such depository institution;
> (b) withdrawing cash from preestablished lines of credit provided by such depository institution;
>
> (c) transferring funds among accounts at such depository instituton;

(d) transferring funds from accounts at such depository institution or from preestablished lines of credit provided by such institution for any purpose;

(e) inquiring about account or credit balances at such depository institution;

provided that the establishment of such terminal was consistent with applicable law and that such terminal is operated and maintained in accordance with applicable Federal and State laws and regulations.

Section 5. An entity that owns, leases or operates an electronic terminal that was established in a manner consistent with applicable law and that is operated and maintained in accordance with applicable Federal and State laws and regulations may permit the depositors of any depository institution, wherever located, to use such terminal for the purposes set forth in section 4 of this Act.

Section 6. The provisions of sections 4 and 5 of this Act shall neither expand nor limit the authority of any depository institution or other entity to own, establish, maintain or operate any electronic terminal, nor shall the purposes set forth in section 4(a) through (e) exclude any other uses of electronic terminals that are consistent with applicable laws.

Although section 4 of the bill authorizes only the withdrawal of cash (including equivalents such as travelers' checks or scrip redeemable for merchandise), payments and balance inquiries, section 6 indicates that any other function (e.g. deposit-taking) which may be authorized in some jurisdictions is not precluded by this bill. Moreover, the language in section 4 regarding depository institutions and their depositors is not intended to limit the rights of nondepository institutions. It merely recognizes that existing restrictions only apply to depository institutions.

Sections 5 and 6 apply to the terminals of depository institutions as well as the terminals of any other entity provided that they are established and operated in accordance with law. Thus, this bill would leave to the states the powers they currently have to regulate the deployment of EFT terminals. If a terminal had been deployed in accordance with whatever state or federal laws might be applicable to its deployment, then this bill would authorize its use in any local regional, national or international interchange. If applicable laws, including state laws, forbade its deployment, this bill would not override such state or federal deployment laws.

Sections 4 and 5 work together to authorize electronic terminal interchange. Section 4 authorizes depository institutions to permit their depositors to use electronic terminals regardless of where the terminals are located. Section 5 permits any terminal owner, lessor or operator to make its terminals available to depositors from any depository institution regardless of where the institution is located.

We believe that this legislative proposal does no more than recognize the legitimacy of the myriad interstate EFT interchange systems that already exist. By enunciating a uniform national policy in favor of such interchange Congress would neither promote nor foreclose any changes in the present geographic restrictions on interstate financial service delivery. States would retain whatever rights they currently have to set rules for intrastate terminal deployment as long as such rules did not obstruct EFT interchange. Also, no interest group would be favored at the expense of another. The main effect of the bill would be to create legal certainty where there is now an environment of confusion and ambiguity.

Mr. Chairman, we believe that consumers today are enjoying significant benefits from EFT systems, and they are eager to have more, for which much of the necessary technology already exists. We believe that legislators and regulators have also come to appreciate the benefits of EFT, and we believe that the 1980's will be the decade in which the EFT dreams of the 1960's and 1970's become realities.

It is doubtful that we will become either a cashless or checkless society in your lifetime or mine. Throughout history, as each new payment mechanism entered the marketplace, it did not replace existing ones. Rather, all the world's payment mechanisms have been layered one on top of the other. Those that have been most used at any point in time are the payment mechanisms that the users of that time -- the consumers -- have found to be the most convenient. So too will it be with electronic funds transfer.

Mr. Chairman, on behalf of the EFT Association I would like to express our appreciation for this opportunity to express our views. I will be happy to answer your questions and to provide you with any further information on EFT that you might find useful.

ATTACHMENT A

S. ________________

IN THE SENATE OF THE UNITED STATES

Mr. _____________ introduced the following bill, which was read twice and referred to the Committee on _______________________.

A BILL

To authorize the interchange of electronic terminals to perform certain electronic funds transfers.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Electronic Funds Transfer Interchange Act of 1983."

FINDINGS

Section 2. The Congress finds that the deployment of electronic funds transfer systems has benefited consumers in many significant ways, and that providing maximum consumer convenience and choice in using funds transfer and credit-extension services will serve the public interest. The Congress finds that many depository institutions and others are engaged in interchanging the electronic terminals that they own or use in order to broaden the areas in which consumers may obtain these services, and that nationwide interchange of electronic terminals will serve the public interest.

Section 3. DEFINITIONS

As used in this act -

(a) the term "depository institution" shall have the meaning ascribed to it in section 19(b) of the Federal Reserve Act (12 U.S.C. 461(b)); and

(b) the term "electronic terminal" shall have the meaning ascribed to it in the Electronic Fund Transfers Act (15 U.S.C. 1693(a)(7)).

INTERCHANGE

Section 4. Notwithstanding any limitations on its own authority to establish, own, operate or maintain electronic terminals, a depository institution may, without regard for terminal location, permit its depositors to use any electronic terminal for the following purposes:

(a) withdrawing cash from accounts maintained at such depository institution;

(b) withdrawing cash from preestablished lines of credit provided by such depository institution;

(c) transferring funds among accounts at such depositiory institution;

(d) transferring funds from accounts at such depository institution or from preestablished lines of credit provided by such institution for any purpose;

(e) inquiring about account or credit balances at such depository institution;

provided that the establishment of such terminal was consistent with applicable law and that such terminal is operated and maintained in accordance with applicable Federal and State laws and regulations.

Section 5. An entity that owns, leases or operates an electronic terminal that was established in a manner consistent with applicable law and that is operated and maintained in accordance with applicable Federal and State laws and regulations may permit the depositors of any depository institution, wherever located, to use such terminal for the purposes set forth in section 4 of this Act.

Section 6. The provisions of sections 4 and 5 of this Act shall neither expand nor limit the authority of any depository institution or other entity to own, establish, maintain or operate any electronic terminal, nor shall the purposes set forth in section 4(a) through (e) exclude any other uses of electronic terminals that are consistent with applicable laws.

ATTACHMENT B

DEFINITIONS RELATED TO PROPOSED ELECTRONIC FUNDS TRANSFER INTERCHANGE ACT OF 1983

12 U.S.C. §461(b)(1)

(A) The term "depository institution" means --

(i) any insured bank as defined in section 1813 of this title or any bank which is eligible to make application to become an insured bank under section 1815 of this title;

(ii) any mutual savings bank as defined in section 1813 of this title or any bank which is eligible to make application to become an insured bank under section 1815 of this title;

(iii) any savings bank as defined in section 1813 of this title or any bank which is eligible to make application to become an insured bank under section 1815 of this title;

(iv) any insured credit union as defined in section 1752 of this title or any credit union which is eligible to make application to become an insured credit union pursuant to section 1781 of this title;

(v) any member as defined in section 1422 of this title;

(vi) any insured institution as defined in section 1724 of this title or any institution which is eligible to make application to become an insured institution under section 1726 of this title; and

(vii) for the purpose of sections 248(o), 342 to 347, 347c, and 372 of this title, any association or entity which is wholly owned by or which consists only of institutions referred to in clauses (i) through (vi)

15 U.S.C. §1693a

(2) the term "account" means a demand deposit, savings deposit, or other asset account (other than an occasional or incidental credit balance in an open end credit plan as defined in section 1602(i) of this title), as described in regulations of the Board, established primarily for personal, family, or household purposes, but such term does not include an account held by a financial institution pursuant to a bona fide trust agreement;

* * *

(6) the term "electronic fund transfer" means any transfer of funds, other than a transaction originated by check, draft, or similar paper instrument, which is initiated through an electronic terminal, telephonic instrument, or computer or magnetic tape so as to order, instruct, or authorize a financial institution to debit or credit an account. Such term includes, but is not limited to, point-of-sale transfers, automated teller machine transactions, direct deposits or withdrawals of funds, and transfers initiated by telephone. Such term does not include --

(A) any check guarantee or authorization service which does not directly result in a debit or credit to a consumer's account;

(B) any transfer of funds, other than those processed by automated clearinghouse, made by a financial institution on behalf of a consumer by means of a service that transfers funds held at either Federal Reserve banks or other depository institutions and which is not designed primarily to transfer funds on behalf of a consumer;

(C) any transaction the primary purpose of which is the purchase or sale of securities or commodities through a broker-dealer registered with or regulated by the Securities and Exchange Commission;

(D) any automatic transfer from a savings account to a demand deposit account pursuant to an agreement between a consumer and a financial institution for the purpose of covering an overdraft or maintaining an agreed upon minimum balance in the consumer's demand deposit account; or

(E) any transfer of funds which is initiated by a telephone conversation between a consumer and an officer or employee of a financial institution which is not pursuant to a prearranged plan and under which periodic or recurring transfers are not contemplated;

as determined under regulations of the Board;

(7) the term "electronic terminal" means an electronic device, other than a telephone operated by a consumer, through which a consumer may initiate an electronic fund transfer. Such term includes, but is not limited to, point-of-sale terminals, automated teller machines, and cash dispensing machines;

The CHAIRMAN. Thank you, Mr. Hefner.
Mr. Nugent.

MICHAEL NUGENT, SPECIAL BANKING AND TELECOMMUNICATIONS COUNSEL, ELECTRONIC DATA SYSTEMS, INC., WASHINGTON, D.C., ON BEHALF OF ADAPSO

Mr. NUGENT. Mr. Chairman, Senator Hecht, good morning. My name is Michael Nugent, I am special banking and telecommunications counsel for Electronic Data Systems, or EDS as the company is called. EDS is an international computer services firm headquartered in Dallas, Tex. I am testifying today on behalf of the Association of Data Processing Service Organizations, or ADAPSO, as the association is more commonly known in the acronym-prone computer industry.

I was also deputy general counsel to ADAPSO before coming to EDS. I am filling in for Ken Riedlinger, who had to stay in Texas today. We apologize for that.

I wish to thank the committee for this opportunity to appear before you today to express our views on several critical matters regarding the financial services industry.

Before summarizing for you our written statement, let me tell you who we are and why we are here. ADAPSO is the trade association of the Nation's computer services industry. Its members provide the public with an enormous range of financial and economic services through a variety of computer service techniques.

In 1982 ADAPSO's 600-plus members accounted for roughly half of the industry's $25 billion in revenues. EDS is among the largest computer service firms in the country. The commercial systems group of EDS provides computer services to approximately 700 banks and savings and loans with over 10 million accounts and well over 3,000 credit unions having almost 8 million members.

In this area of our business alone, EDS processes over 1.5 billion transactions a year. So you can see that depository institutions are our customers, our suppliers of credit, and our potential competitors as well.

EDS, like most of ADAPSO's members, is an active and critically important participant in the delivery of banking and financial services. As such, we are directly affected by the work of this committee, especially where it relates to the restructuring of the financial services industry.

I have basically three points this morning which are summarized in our written statement. The first point pertains to the range of permissible data processing activities which should be allowed to depository institutions. The second deals with the appropriate vehicle for expansion of the product and service powers of depository institutions. And third, we ask this committee to investigate in-depth Federal Reserve competition with the private sector in the provision of electronic payment services.

OFFER UNSPECIFIED DATA PROCESSING TO THE PUBLIC

Let me turn to my first point. It has been proposed that depository institutions should be permitted to offer unspecified data processing to the public. There is danger in this talk, since it fails to recognize what data processing is. Data processing per se is simply computer technology which can be employed to perform virtually unlimited kinds of services from racetrack handicapping to voter surveys to demand deposit accounting to site selection for a McDonald's franchise.

As a neutral technology, data processing is neither banking nor financial in nature. If Congress permits depository institutions to offer unspecified data processing to the public, there is great danger that this authority will conflict with the longstanding separation of banking from commerce.

The authority to engage in unspecified data processing services carries with it the authority to provide an unlimited range of services. We believe that the Congress should look at the nature of the services to be provided through data processing technology.

We have stated our position in our written statement that purely economic data processing services and general purpose data processing services are clearly and purely commercial data processing into which banks and depository institutions in general should not be allowed. It may well be, Mr. Chairman, that the Congress may determine that financial data processing services are permissible for depository institutions, but again the Congress should specify those financial services in which depository institutions may engage using data processing technology.

Whether a grant of authority to engage in unspecified data processing, or economic services or general purpose services, is legal under the current Bank Holding Company Act is at issue in ADAPSO's fully submitted litigation against the Board of Governors of the Federal Reserve System. We are awaiting a decision by the U.S. Court of Appeals for the District of Columbia Circuit.

EXPANSION OF FINANCIAL ACTIVITIES

My next point, Mr. Chairman, deals with the appropriate vehicle for the expansion of the product and service powers of depository institutions. Should the Congress grant depository institutions the authority to engage in an expanded range of financial activities, they should be permitted to do so only through a holding company subsidiary that is rigidly separated from the depository institution itself.

This in fact has been ADAPSO's position since the late 1960's, whenever regulated entities with Government franchises are permitted to engage in unregulated or competitive endeavors. In fact, Mr. Chairman, this industry was allowed to grow from an uncertain infancy when the 1956 consent decree with IBM required IBM to set up a separate subsidiary for its service bureau business.

In 1960 the independent software products industry exploded when IBM was required to explicitly price its software. You, of course, are well aware of the FCC's reliance on the separate subsidiary mechanism for the conduct of unregulated activities by AT&T and other carriers.

There is a surprising consensus on the holding company subsidiary as a proper vehicle. I think it may be the only consensus that we have got, except for the location of this hearing room.

This acceptance of the holding company subsidiary has been voiced by regulators, by the Administration, depository institutions, and potential competitors alike. The remaining debate is focused on whether the separate subsidiary approach will work and whether it should be applied to smaller institutions.

We believe it will work, but that the efficacy of a separate subsidiary turns directly on the quality and quantum of separation between the depository institution and its competitive subsidiary.

We have outlined on pages 13 and 14 of our written testimony six principles which we believe should govern the nature and quality of the separation between the depository institution and its competitive affiliate. We believe that the holding company approach is a good approach. It will permit depository institutions to get, on a timely basis, whatever legitimate authority they need to compete with other financial institutions. It will adequately insulate the essential functions of depository institutions as well as depositors' funds from the risks of competitive activity.

And we also believe, and we are prepared to accept, that the holding company subsidiary will adequately identify and minimize the opportunity for competitive subsidiaries to exploit the unfair marketplace advantages that would flow from otherwise unrestricted affiliation with depository institutions.

We also believe that the separate subsidiary requirement is an appropriate quid pro quo for the relaxation of the stringent public policy-based limitations on the product and services powers of depository institutions.

FED COMPETITION WITH THE PRIVATE SECTOR

Finally, Mr. Chairman, I would like to deal with the point of Federal Reserve competition with the private sector and whether that competition is proper, necessary, and fair. This competition is between the Federal Reserve and computer service firms depository institutions and Mr. Lee's organization alike.

In a nutshell, the Federal Reserve continues to dominate this Nation's automated clearinghouse system with 36 of 37 of those organizations operating under the auspices of the Federal Reserve. The Federal Reserve continues to receive widespread criticism that its prices for its ACH services are subsidized and are so unfairly low that they discourage private sector entry into this area.

Another part of the controversy surrounding the Federal Reserve is its FRCS-80, the Federal Reserve Communications System for the 1980's, which is a sophisticated, general purpose, data communications network. It will interconnect Federal Reserve Banks, the Treasury Department, ACH processing sites, and financial institutions. The technical characteristics of FRCS-80 are such that it greatly increases the likelihood that the Federal Reserve will expand its role in providing commercial transactions for the private sector.

FRCS-80 also enables the Fed to have a significant data processing and transmission role in point-of-sale transactions, telephone bill payment transactions, and ATM transactions. We are concerned about this, Mr. Chairman. We ask that your committee take an in-depth look at the situation.

That concludes my remarks. I will be happy to answer any questions. Thank you very much for the opportunity to appear before this committee.

[The complete statement follows:]

WRITTEN

STATEMENT

OF

KENNETH G. RIEDLINGER

on behalf of

THE ASSOCIATION OF DATA PROCESSING SERVICE ORGANIZATIONS

ON

THE DOMESTIC FINANCIAL SERVICES INDUSTRY

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

June 9, 1983

Mr. Chairman and Members of the Committee:

My name is Kenneth G. Riedlinger. I am Group Vice President and a Director of Electronic Data Systems Corporation which is an international computer services firm headquartered in Dallas, Texas. I am testifying today on behalf of the Association of Data Processing Service Organizations or ADAPSO as the Association is more commonly known in the computer services industry.

I wish to thank the Committee for this opportunity to appear before you today and to express the views of ADAPSO on several critical matters involved in your timely scrutiny of conditions in the financial services industry. An active member of ADAPSO, EDS joins in the Association's views.

ADAPSO is the principal trade association of this nation's computer services industry. Its members provide the public with an enormous range of practical services, predominantly financial and economic in nature, through a variety of computer service techniques. These techniques include local batch processing; the provision of computer software for large, mainframe computers and software for small business and home computers; software design and consulting; facilities management arrangements; and remote access data processing and information retrieval. In 1982, ADAPSO's 600-plus members accounted for more than half of the industry's $25 billion in revenues.

Electronic Data Systems Corporation and Automatic Data Processing, Inc. are the two largest computer service firms in the country. EDS has over 13,000 employees and operates in 50 states and worldwide. The Commercial Systems Group within EDS, of which I am Vice President, provides computer services to approximately 700 banks and savings-and-loans with over 10 million accounts and well over 3,000 credit unions having almost 7 million members. In this area of our business, EDS processes over 1.5 billion transactions a year.

Our principal vehicle for delivery of computer services to depository institutions is the facilities management arrangement where we become, in essence, the data processing department of the institution served. Our responsibilities under this arrangement include design of the computer system, training, programming, implementation and operation of the computer systems we install, and establishment of the communications network where necessary. Through facilities management and, in addition, through minicomputer systems and remote computer processing arrangements, EDS performs a full range of services from demand deposit accounting and money market account processing to automated teller machine network services. EDS, like the preponderance of ADAPSO's membership, is an active and critically important participant in the delivery of banking and financial services to the consumer. We are the specialists who make innovative computer technology available to this nation's depository institutions.

As such, ADAPSO members and EDS are directly affected by the work of this distinguished Committee, especially where your efforts lead to restructuring of depository institutions. In the limited amount of time available to me today, I would like to touch briefly upon three points of considerable interest to the computer services industry. I will summarize these points at the outset.

Our first point is that data processing *per se* is simply a technology which can be applied to perform virtually unlimited kinds of services ranging from financial services such as accounts payable and receivable reporting to orange crop prediction in the state of Florida. Accordingly, if the Congress wishes to permit depository institutions entry into the data processing business, Congress should define that business in terms of those services which depository institutions may offer to the public through data processing. Otherwise, Congressional authorization of unspecified "data processing" as a permissible activity for depository institutions will include the authority to offer purely commercial data processing services which are totally unrelated to banking or finance.

My second point is that the holding company subsidiary is an essential vehicle for any expansion of the permitted product and service activities of depository institutions. The strident and conflicting views of interested parties will be effectively dealt with if depository institutions are permitted to engage in an expanded range of financial activities only through a subsidiary which is rigidly separated from the depository institution itself. Such structural separation of the banking and nonbanking activities of banks, savings-and-loans and savings banks would not meaningfully impair the competitiveness of such institutions with non-depository, financial organizations. Moreover, depositors' funds would be insulated from the risks and rigors of the competitive activities of depository institutions. In addition, the competitive affiliates of depository institutions would be far less able to exploit the unfair competitive advantages that flow from unrestrained relationships with depository institutions having credit-granting franchises. The key to the holding company subsidiary as a promising solution to the various dilemmas of asset deregulation, however, turns on the quality and quantum of separation between a depository institution and its competitive affiliates.

My third point is basically a plea to this Committee to investigate in depth the entry of the Federal Reserve System into the data processing and data transmission business. At this time, the Federal Reserve is well along in its campaign to compete with private sector providers of electronic payment services. The Federal Reserve is competing with computer service firms and depository institutions alike, without specific Congressional authorization. We question whether this activity is necessary, proper and, to this point, fairly priced. We fear that continued Federal Reserve competition will deter entry by private sector firms into the electronic payment services marketplace, or will drive them out altogether. The proper role of the Federal Reserve is a critical part of any analysis of the conditions of the financial services industry.

"Data Processing" by Depository Institutions

I turn now to my first point which deals with the proposed expansion of depository institution powers to include "data processing" authority. Both banking organizations and federal banking regulators have pressed for Congressional allowance to depository institutions to engage in unspecified "data processing" activities.[1] In fact, previous draft versions of the Bank Holding Company Deregulation Act, introduced last year as S. 2490 and H.R. 6762, have included "data processing" as a permissible activity for subsidiaries of bank holding companies.

The problem with this approach is that it contains no definition of permissible "data processing," much less one that comports with the reality of the data processing marketplace. "Data processing" is by definition a neutral computer technology which can be and has been employed to automate virtually every business discipline or function. As a technology, "data processing" can never be inherently banking or even finanical in nature.

"Data processing" can be characterized as a financial or non-financial activity only after analysis of the particular service to be performed using data processing technology. In fact, a firm cannot "process" data unless the data is being processed for a particular purpose or with a certain end service in mind. Our customers do not contract for the random processing of data; rather, they seek specific business services such as payroll preparation, Regulation E compliance, loan accounting, cash management, and so on.

Any blanket authorization to engage in undefined "data processing" activities carries with it the authorization to offer any service which can be performed through "data processing." "Data processing" as a technology can be applied to perform a virtually unlimited array of services which can include demand deposit accounting but also race track handicapping, business forecasting, marketing analysis, inventory control or site selection for a MacDonald's franchise. As a result, if Congress permits depository institutions to engage in "data processing" activities without limiting the nature of the services to be furnished, Congress will have blindly authorized the provision of services (through data processing) having no relation whatsoever to banking or finance.

This result cannot be intended even by the most ardent advocate of expansion of depository institution powers. This result conflicts with the current, longstanding federal prohibition on the extension of banking into general commerce--a prohibition which all seemingly agree is still valid.

To avoid depository institution diversification into non-financial, commercial data processing endeavors, Congress should analyze the nature of the services to be performed through data processing technology. If there is a legitimate and pressing need for depository institutions to offer financial data processing services, Congress should specify those financial services which depository institutions may provide without breaching the wall between banking and commerce.

In our view, depository institutions should not be permitted to offer to the public purely economic data processing services including catalogue shopping, business planning, product analysis, economic data base services and general ledger services. It is also our position that depository institutions should not be permitted to offer to the public general purpose data processing services which permit unlimited, non-financial applications.

These general purpose services include the provision of raw computer power (e.g., computer timesharing services) to customers so that they can engage in whatever data processing functions they choose. Also impermissible should be the provision of computer access to or purchase of general modelling, analytical and forecasting software programs which enable the customer to engage in unrestricted, non-financial functions. These services are called "general purpose" because, by design and in response to the marketplace, they furnish highly flexible data processing technology to the customer so that the customer can employ this technology to arrive at solutions and services limited only by the particular, changing needs of the customer.

Economic and general purpose data processing services have no relation to banking or finance; these are strictly commercial data processing services. A grant of authority to depository institutions to engage in such services or to engage generally in unspecified "data processing" activities would make a mockery of the federal policy separating banking from commerce. Whether such a grant of authority is legal under the current Bank Holding Company Act is directly at issue in the fully submitted ADAPSO litigation against the Board of Governors of the Federal Reserve System.[2] We are awaiting a decision by the U.S. Court of Appeals for the District of Columbia Circuit. We submit that a grant of authority to engage in unspecified "data processing" activities or authority to offer economic and general purpose data processing services would likewise be unlawful under the "financial activity" standard of the proposed Bank Holding Company Deregulation Act of 1982.[3]

Let me make our position clear before moving on to my second point today. ADAPSO does not seek to deny the benefits or use of data processing technology to depository institutions in the performance of the banking activities authorized by their charters. We do not seek a federal ban on all data processing activities by depository institutions nor are we seeking a blanket prohibition on the offering to the public by depository institutions of services which are provided by means of the application of data processing technology.

The true issue pertains to the definition of those services which depository institutions should be permitted to offer to the public through data processing technology without violating the federal prohibition on commercial endeavors by banking organizations. In our view, the public offering of economic and general purpose data processing services by depository institutions should be prohibited in light of current federal policy. In addition, the public offering of undefined "data processing" by depository institutions should be prohibited for similar reasons.

It may will be justifiable to permit the public offering of directly financial data processing services by depository institutions, but Congress must specify those financial services in which depository institutions may engage through data processing technology and generally. Congress should also define what it means by "financial" and whether this definition moves beyond existing dictionary definitions. Otherwise, Congress invites years of litigation as has occurred over the meaning of the "closely related to banking" standard of the Bank Holding Company Act.

The holding company subsidiary as the appropriate vehicle for expanded depository institution activities

Should Congress grant depository institutions the authority to engage in an expanded range of financial activities, including the provision of financial data processing services, they should be permitted to do so only through a holding company subsidiary rigidly separated from the depository institution itself. Critically important public interest considerations, and the legitimate interests of potential competitors of diversified depository institutions, commend the holding company subsidiary as the only proper vehicle for conduct of expanded financial activities by institutions.

There is a surprising consensus emerging on the holding company subsidiary as a viable and appropriate mechanism for expanded financial activity by depository institutions. This approach has been endorsed by the Administration, the Comptroller of the Currency, the Chairmen of the Federal Reserve Board and the FDIC, the Executive Secretary of the Federal Financial Institutions Examination Council, banking industry trade associations, trade associations of potential competitors of diversified depository institutions and the Antitrust Division of the Department of Justice.

Congress itself has endorsed the holding company subsidiary approach to expanded financial activities. This took place last year when, in the Export Trading Company Act, Congress permitted banking organizations to engage in export trade services but only through a subsidiary of a bank holding company. Since the late 1960's ADAPSO has maintained that whenever regulated entities with government-granted franchises are permitted to engage in unregulated or competitive activities, they should be permitted to do so only through a maximally separated subsidiary.

The separate subsidiary approach to asset deregulation for depository institutions will serve the various interests affected by expanded product and service powers for these institutions. It should permit depository institutions to obtain, on a timely basis, whatever legtimate authority they need to compete with non-depository, financial organizations. It should adequately insulate depositors' funds from the risks and demands of competitive activities. It should preserve and protect the essential role and functions of depository institutions in our nation's economy. Finally, the separate holding company subsidiary approach should adequately identify and minimize the opportunity for competitive subsidiaries to exploit the unfair, marketplace advantages that otherwise would flow from unrestricted affiliation with depository institutions having credit-granting franchises.

The debate that remains is focused on whether the separate subsidiary approach will serve effectively the competing interests and needs identified above. It is our position that the holding company subsidiary tool will work and that its efficacy is directly a function of the extent of separation between the depository institution and its competitive, "financial" subsidiary. We believe that this separation ought to be rigid and structural, established by statute, and accompanied by simple yet full disclosure of all transactions and dealings between the separated entities.

What we have in mind in terms of statutory separation requirements for holding companies with depository and competitive subsidiaries would be based on the following principles:

1. A competitive subsidiary shall be a separate and independent corporate entity with capitalization and financing from unaffiliated sources or, at the minimum, from affiliated sources on the same terms and conditions as would apply to a non-affiliated competitor similarly situated;
2. A competitive subsidiary shall exist as a separate, independent and profit-oriented operation and shall not be subsidized in anymanner by an affiliated depository institution, either directly or indirectly through the parent holding company or through other affilates of the depository institution;
3. The services performed by a competitive subsidiary shall be explicitly priced and shall not be paid for on the basis of imputed earnings of deposits maintained at, or loan arrangements with, an affiliated depository or other subsidiary of the parent holding company;
4. The conduct of all business between a depository institution and its competitive affiliates shall be on a completely arm's length basis without any

preference arising out of affiliation, and shall be performed pursuant to contract publicly filed and at fully compensatory price, and in no event, less than market price;

5. A depository institution shall not discriminate against competitors of its affiliates as to the availability of, or the terms and conditions for,(1) credit or loans, and (2) account information and debit/credit functions necessary to the performance of data processing services;
6. An affiliated competitive subsidiary and depository institution shall not disclose to the other any proprietary customer information unless such information is made publicly available on an identical basis.

These principles for the separate holding company subsidiary engaged in competitive, "financial" activities are derived in large part from decisions of the Federal Reserve Board itself and persuasive testimony presented to this Committee.[4] The structrual separation and reporting principles are designed to insulate the depository institution from the high risk and costs associated with affiliate entry into the data processing services marketplace,[5] among others, should such entry be permitted by Congress in the first place. These principles should also serve to minimize if not nullify the opportunity for depository institutions to subsidize the activities of their competitive affiliates.

These principles of separation are also structured to deal with the enormous and unfair competitive advantages possessed by affiliates of depository institutions having credit-granting franchises. Chief among these advantages is the ability of banks, and now savings-and-loan associations and savings banks, to control significant commercial loan transactions and to grant credit.

Access to commercial loans and credit generally is of utmost significance, indeed, essential to all businesses, large and small alike. Businesses go to substantial lengths to protect, create and enhance a credit relationship with a banking organization, in part because the credit process is a discretionary one and money is scarce.

This effort to secure access to credit and to retain the banking organization's favor takes many forms. Of principal concern is where this credit power induces the existing or potential customer to patronize other affiliates of the depository institution having credit-granting powers, in the hope that the customer will have a chance or a better chance to obtain lifeblood credit on favorable terms.

The credit power, then, results in more business for the affiliate, not on the basis of the quality or price of the affilate's offering but, rather, as a means to obtain access to the banking institution's scarce commodity, credit. This scenario has been called the voluntary tie-in. Its consequences are the same as those of coercive tie-ins--competitors of the institution's affiliate are foreclosed from part of the market for reasons unrelated to the competitive merits of their products and consumers may be overcharged or may be induced by the credit power to make unnecessary purchases.

Two marketing developments taking place in the bank industry, in particular, threaten proliferation of the voluntary tie-in. "Full relationship pricing" dictates that the more business a customer conducts with his banking institution, the greater the price discount on any one service taken. In addition, banking organization employees are now urged to "cross-sell" the full range of products and services available from the institution when someone opens an account, seeks a loan or otherwise conducts usual bank business. These developments only enhance the possibility that a business or individual will patronize the competitive subsidiaries of a banking organization in order to curry the favor of the credit-granting depository institution.

The six structural separation and reporting principles proposed will serve to identify and minimize the opportunity for commercial exploitation of the credit-granting power by affiliates of depository institutions and by the institutions themselves. These principles will also reduce the continuing anticompetitive practice whereby free or below-cost data processing services are provided to correspondent banks and customers generally in exchange for the deposit or maintenance of non-interest bearing, "compensating" balances with the depository institution.

The separate subsidiary approach that we have proposed is not a fail-safe mechanism but it has worked in other situations. The computer services industry was able to grow from an uncertain infancy when IBM was required by its 1956 consent decree with the Department of Justice to conduct its "service bureau business" in a subsidiary separated from its computer equipment business.[6] Similarly, the software products business realized phenomenal growth after IBM, under the pressure of litigation, began to price explicitly its software in the late 1960's. Congress is well aware of the reliance by the Federal Communications Commission on the separate subsidiary mechanism for the unregulated, competitive activities of AT&T and regulated communications carriers.

We believe that the separate subsidiary requirement for the conduct of expanded financial activities by depository institutions is an appropriate quid pro quo for relaxation of the stringent, public-policy based limitations on the product and service powers of these institutions. Some compelling arguments have been made that small banks as well as small savings-and-loan associations and savings banks, and that credit unions generally, should be exempted from the requirement that expanded financial activities be conducted through a holding company subsidiary. Notwithstanding these arguments, some adequate form of separation is called for, if only to identify and minimize the opportunities for risky and detrimental cross-subsidy.

The role of the Federal Reserve in the provision of electronic payment services

My final point today is in the form of a request. ADAPSO and EDS ask this Committee to include within its schedule of hearings an investigation of the propriety and fairness of current Federal Reserve competition with the private sector. The Federal Reserve System, a regulator and a government organization, is embarked on a dramatic campaign to compete with both computer service firms and depository institutions in the marketplace for electronic payment services.

The Federal Reserve System continues to dominate this country's system of automated clearinghouses (ACH's). Of the 37 operational ACH's, 36 are run under the auspices of the Federal Reserve which provides settlement services and, in competition with the private sector, clearing and delivery services. The Federal Reserve continues to receive widespread and sharp criticism that its prices for its ACH, check collection and wire transfer services are subsidized with revenues from its monetary policy operations. As you well know, the Federal Reserve first charged for its electronic payment services only after it was specifically required to do so by the Monetary Control Act of 1980.. The criticism continues that the Federal Reserve's prices for its ACH services, among others, are so unfairly low they discourage the private sector from even considering entry into this area. It is also argued that the Federal Reserve's proper role in the ACH area should be one involving solely settlement functions.

This is only one part of the controversy surrounding Federal Reserve competition in the electronic payments marketplace. The Federal Reserve has further entrenched and enhanced its role in electronic payment services through its establishment and management of the Federal Reserve Communications System for the Eighties (FRCS-80).

FRCS-80 is a sophisticated, general purpose data communication network which will interconnect the Federal Reserve Banks, The Treasury Department, ACH processing sites and financial institutions. The technical characteristics of FRCS-80 are such that it is practical if not compelling for the Federal Reserve to expand its role in providing commercial transactions for the private sector. FRCS-80 also enables a significant data processing and transmission role for the Federal Reserve in point-of-sale transactions as well as telephone bill payment and automated teller machine transactions. It has been reported that the Federal Reserve has been marketing small computers to induce financial institutions to participate on an accelerated basis in the ACH and FRCS-80 services provided by the Fed.[7]

Private sector firms, banking trade associations, ADAPSO, NTIA, the Antitrust Division of the Department of

Justice, the staff of the FTC's Bureaus of Competition and Economics have each criticized the subsidized, below-cost and unfair pricing of ACH services by the Federal Reserve. These groups have likewise charged that the Fed's enhanced participation in electronic payment services, through FRCS-80, is a substantial deterrent to private sector entry into electronic payment services. Much of this has transpired without ongoing and specific Congressional examination and approval.

These twin developments in the electronic payments field pose significant competitive questions and cast doubt as to whether an otherwise ready and willing private sector will become involved in the delivery of electronic payment services. The Federal Reserve's current role is this area of the financial services industry is highly disturbing. We know, Mr. Chairman, that this is an area of significance to you and to Senator Proxmire, as demonstrated by your pointed letter of July 24, 1980, to Chairman Jay Janis of the Federal Home Loan Bank Board regarding its role in the settlement and processing of NOW drafts. Whether the Federal Reserve System should continue its dominant and accelerating role in the electronic payments service area and, if so, at what price, are questions we ask this Committee to investigate and resolve before events and commitments outrun any remedy.

On behalf of ADAPSO and EDS, thank you for your time this morning. We look forward to working with you and your fine staff to arrive at legislation that creates a "level playing field" for all participants in the financial services industry, including computer service firms.

FOOTNOTES

1. *See*, *e.g.*, *Financial Institutions Restsructuring and Services Act of 1981, Hearings on S. 1686 et al., Before the Senate Committee on Banking, Housing and Urban Affairs*, 97th Cong. 1st Sess. (1981), at 433 (statement of Paul Volcker, chairman Board of Governors, Federal Reserve System); Written Statement of William M. Isaac, Chairman, Federal Deposit Insurance Corporation, *Hearings on the Conditions of the Domestic Financial Services Industry Before the Senate Committee on Banking, Housing and Urban Affairs*, 98th Cong., 1st Sess., at 7 (April 27, 1983).

2. *ADAPSO, et al. v. Board of Governors of the Federal Reserve System*, Nos. 82-1910, 82-2108 (D.C. Cir., oral argument conducted April 26, 1983); *see also ADAPSO et al. v. Comptroller of the Currency, et al.*, 77 Civ. 2574 (S.D.N.Y., case placed on suspense calender to await above decision, by Memorandum and Order of the Court, Dec. 15, 1980) (this case involves the extent to which national banks may offer commercial data processing services under the National Bank Act).

3. 128 Cong. Rec. 54562 (Section 9 of S. 2490) (daily ed., May 5, 1982).

4. *See especially* 12 C.F.R. §§225.4(a)(12), 225.125, 225.129 (1982); 12 C.F.R. §225.123 (e) (47 Fed. Reg. 37373 (Aug. 26, 1982)) (accounting separation for data processing services); *Multibank Financial Corp.*, Federal Reserve Board Decision (May 15, 1981) and *The Conifer Group, Inc.*, Federal Reserve Board Decision (April 3, 1981) (structural and inter-company dealings separation for data processing services); Written Statement of William M. Isaac, Chairman, Federal Deposit Insurance Corporation, *supra* note 1, at 7-8; *Securities Activities of Depository Institutions, Hearings on S. 1720 Before the Senate Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs*, 97th Cong., 2nd Sess., at 68,89, 101-02 (regarding different name requirement) (1982).

5. According to the ABA-commissioned study, "Assessment of Business Expansion Opportunities for Banking" (Arthur Young & Company, February, 1983), the data processing services business involves medium to high capital requirements, high skill intensity, a significant critical mass in some cases, limited product and service synergism with banking, and substantial risk prompted by this highly obsolesence sensitive marketplace. In addition, data processing entry by banking institutions is *not* motivated by defensive considerations although it is a highly profitable market. *See id*. at 24,31-32.

6. *United States v. International Business Machines Corporation*, [1956] Trade Cas. (CCH) ¶68,245, at 71,125.

7. *American Banker*, "New Links Opening to Fed Services", at p.1, col. 1 (Sept. 29, 1982).

The CHAIRMAN. Thank you, Mr. Riedlinger.

NONBANK-BANKS ENGAGED IN OTHER ENTERPRISES

Mr. Evans, you make the point that consumer banks or, as we become used to the term, "nonbank banks," have actually been operating for decades in the form of industrial banks which provide deposit services for the public. In addition, these banks have been affiliated with entities engaged in a lot of different types of enterprises.

Can you tell the committee what, if any, lessons or experiences we can learn from these combination of deposit-taking institutions with other enterprises?

Mr. EVANS. I think the lesson is a positive one. There has been no evidence that I know of or am aware of of conflict that has surfaced in any distinct fashion because of these affiliations.

I am not saying that such attempts are not made from time to time, as has happened in banks and in other areas. But in general, these companies have seemed to coexist and to operate without a diversion of depositors' funds to conflicting uses. And I say this from experience now with these banks going back, as I said earlier, to 1909. There is no notable instance where a conflict has produced a depositor loss.

The CHAIRMAN. What is your feeling about the ability of banks being able to be separated or protected from their affiliates? This goes back to the basic argument we have had through the last couple of years about if additional services are given, specifically those in the original S. 1720—municipal revenue bonds and money market funds—the argument between the Fed Chairman and the Secretary of the Treasury about whether banks can absorb these additional services within the banking organization or whether they must be a separate affiliate.

The example I continue to use on my side of the argument is the REIT situation. I do not see how being in a separate affiliate really made any difference or provided any great protection to the parent organization.

Mr. EVANS. Let me ask Dr. Durkin to respond to that.

Mr. DURKIN. Mr. Chairman, there is always the risk in a financial institution for an improper or inappropriate use of funds to occur, thereby endangering the depositor. In the cases we are talking about, the consumer banks, that certainly seems to be less of a problem.

With the banking system as a whole and the bank holding companies following the provisions in the Banking Affiliates Act amending section 23(a) of the Federal Reserve Act, it would seem to overcome a lot of those concerns. Using the example of the REIT, the sponsorship of an organization is now included in the definition of a banking affiliate, whereas I understand it previously was not.

The CHAIRMAN. That is correct. Do you feel that 23(a) provides the necessary protection for transactions between institutions and their affiliates?

Mr. DURKIN. I think that 23(a) goes a long way toward that sort of protection. I think most of the risks that have developed in banking arise out of the banking aspects, and it is not clear that the affiliates are the things that are causng the risks. The international loans and the loans to oil drillers and so forth in a difficult economic environment are the things that have caused the risks in banking rather than the relationships with the affiliates.

ADDITIONAL COMPETITION IN MUNICIPAL REVENUE BONDS

What we would like to see is that competition be improved, that competition be allowed to work. A good example, I think, is the one that you mentioned, the municipal revenue bonds. Certain experts—I am not an expert on this—but my understanding is that certain experts believe that additional competition in the area of municipal revenue bonds would be good for the public as a whole. Many of these issues, as you know, are quite small, with a very limited number of bidders. And allowing banks or bank affiliates to enter this market would improve competition in those areas.

The CHAIRMAN. Mr. Lee, you made the observation that an increasing number of securities companies and retail organizations are actually acquiring banks in a deposit-taking capacity. This certainly is taking place and is a big, hot issue. Why do you think these companies are interested in deposit-taking functions in view of the fact that they can purchase funds in the marketplace promptly at a lower price now that we have eliminated deposit rate ceilings? They have been virtually deregulated.

Mr. LEE. I think they want the geographical scope. I think they want the local contact with businesses. I believe that the privity that is developed on the local basis, when they can acquire a smaller, localized organization, assists them in their overall nationwide business. It's an adjunct to their overall money brokering services.

The CHAIRMAN. Mr. Evans, you appear to believe that the status quo is just fine. The loophole by which other commercial enterprises are trying to bar banks is one that should not be closed. Is that accurate?

Mr. EVANS. I don't think the term "loophole" is accurate. It's just that the so-called nonbank banks or consumer banks are complying literally with the requirements of the law, in the sense that they are not making commercial loans. They are taking demand deposits. They are engaging in transaction accounts. They are maintaining reserves required by the various laws.

And yes, we find this to be a satisfactory situation. As I indicated, a toehold entry into the payments system is essentially what we are talking about. Accessing consumer deposits as a source of funds is not the biggest thing here. I think most of our members are concerned about being left outside somehow, out of the payments system, out of the transactions accounts, and want to be able to deliver a full spectrum of services to their consumer customers.

As you know, and I think we pointed out, our access to capital markets traditionally has been quite good. We can compete with the banks now, especially with Reg Q having met its demise.

I think the costs of funds for all financial institutions are largely going to be the same, so it isn't so much that we have to get into that aspect of it so much as we do need to be in the mainstream of a complete delivery of consumer services. That means working on the liability side as well as on the asset side.

By the same token, we would go along with any reasonable adjustment, if it seemed to be required down the road, to assure the safety and soundness of the system, and to avoid any conflict of interest, but there has been no showing of need for that so far.

The CHAIRMAN. Let me change the question just slightly, then, and say that you find no reason to close off that option?

Mr. EVANS. Not now.

The CHAIRMAN. Is "option" better than "loophole"?

Mr. EVANS. The proposed moratorium, I think, is a nonanswer answer to a nonproblem problem. [Laughter.]

Until somebody comes up with some evidence that it's really impinging in any of these three areas, I think the best thing to do is let the competition, innovation, new market services, go on. Let's address it, by all means, if we need to. We would like to participate in it, but not by just shutting down the debate.

The CHAIRMAN. As I have said many times in the last few days, I don't like moratoriums, either. But the steamroller is starting to roll. It's amazing. The people who a few weeks ago were not for the moratorium are suddenly starting to rush toward one.

Mr. EVANS. We named a fourth argument, which is largely turf. I think that has surfaced in the last week or so. Bear in mind that some of our members—who are owned by insurance companies—are very much into the financial services area, through provision of consumer credit.

The CHAIRMAN. Mr. Durkin, do you wish to make a comment?

Mr. DURKIN. Mr. Chairman, I just wanted to add that it would seem with these consumer banks that the problems that are raised about the effectiveness of 23-A wouldn't even come into play. These would be consumer banks, where commercial loans would not be allowed, and so they wouldn't be able to lend the funds to any affiliates, because that wouldn't be a consumer loan. So under the currently existing Bank Holding Company Act, many kinds of concerns would be minimized, for purely consumer operations.

The CHAIRMAN. Mr. Evans, isn't it somewhat lopsided, though, whether we call it a "loophole" or an "option," or an "opportunity," isn't it an opportunity for other types of businesses to get into the banking business, but we're still including banks, not the kind you represent—the commercial banks—from getting into the other side of the equation.

Mr. EVANS. We're not in any sense of the word saying that we're opposed to further allowing banks to offer other products or other services, or even expanding geographically.

I realize that is one aspect of this consumer banking thrust that we are entering into. We are indeed in favor of an open and competitive market. Whatever services the banks feel they can give, whether it's through the bank or an affiliate or through a holding company, that the Congress considers to be consistent with the need for safety and soundness, we would support. We would not be against any such activity on competitive grounds. We're ready, willing, and able to compete on any basis. Essentially, that's why we like the nonbank banks. We need to get in on that aspect of the system. At least that is the perception of some of our members.

RECOMMENDATION TO REDEFINE A BANK

The CHAIRMAN. Mr. Lee, what is your view of Chairman Isaac's recommendation to redefine a bank to include any institution that takes federally insured deposits?

Mr. LEE. The association hasn't actually taken a position on that, but I believe, generally, we would support it.

The CHAIRMAN. Senator Hecht?

Senator HECHT. Thank you, Mr. Chairman.

Mr. Evans, you said that you stand for competitive financial markets, for this reason: it encourages you to promote free-market entry and is a necessary prerequisite for competition.

Specifically, what do you mean by that?

Mr. EVANS. Simply that once any market—I am going to allow Dr. Durkin, who is an expert in this area, to comment.

But simply whenever you limit entry, you are cutting down the number of players, and the fewer, the more comfortable they get with the status quo. There are fewer incentives to innovate and provide efficient services. In other words, all the good aspects of competition are minimized, and, as we pointed out, products become more costly.

Senator HECHT. Do you want to get specific, Dr. Durkin?

Mr. DURKIN. Well, I am not sure what specifics you might find most interesting. Mr. Evans stated the case. We have the antitrust laws, to prevent the mergers of significant competitors, because if the level of competition is reduced, or isn't very high to start with, then we can expect a reduction in the quality and quantity of service along with higher prices. Those are the indicators of noncompetitive markets.

Our association and I personally certainly believe that promotion of competition in financial services is the best thing for the public, and that the public will then receive the quantity and quality of services that it demands at the best possible price. For that reason, we would like to see as many people able to provide them as want to provide them.

Senator HECHT. What do you see our role in regulating this?

Mr. DURKIN. Your role in regulating? I think the most important role in regulating is to prevent the conflicts of interest that might arise and could arise, I think, by a wholesale combination of large-scale commercial enterprises with large-scale commercial financing. That kind of combination—and I can think of many large financial institutions that could combine with many large companies, without naming any of them—might cause there to be a question about the true freedom financial institutions might have in making loans.

For example, the merger of a large steel company with a large bank might cause the steel company to dictate the kinds of loans that the bank might make to other steel companies. We think that kind of thing is unlikely by the development of these consumer banks. We don't like to see that sort of thing develop but we think the best guarantee against it is some care in Congress in looking at the laws, but also the free entry into lending. Even if one bank, for example, is prevented by its steel company from making loans to other steel companies, we have a financial institution makeup in this country with about 20,000 depository institutions able to make commercial loans.

That is the kind of thing we would like to see.

Senator HECHT. Mr. Hefner, in these days that everyone sometimes criticizes bigness, I want to change course and say that because of First Interstate Bancorp, you have kept, probably, more small retailers in business in the last 10 years than anyone else, by the banks' developing the different systems you have had.

I have been in retail for 35 years. We couldn't run retail stores without your operations. Not only that, but small restaurants, big restaurants, couldn't survive in America today—even to the last time I was home, I had my teeth cleaned, and my dentist took my Master Charge.

So all these things are because of your foresightedness to go out and develop different electronic machines. You have made such a significant change in retailing. Every aspect in the last 10 years. What do you see in the next 10 years?

Mr. HEFNER. Senator, I am sure that no one individual has a firm fix on what the future is likely to be. But, the current trends in the nature of delivering electronic financial services to retailers, I think, clearly indicate that some larger and larger percentage of consumers will be using a variety of plastic cards for the acquisition of goods and services at the point of sale. That then implies certain risks to the retailer, and we think electronics can go a long way toward ameliorating those risks. There are systems today that allow retailers to enter data electronically concerning the authenticity of a plastic card and do so quickly, in a single procedure which eliminates the need to look through the rather ubiquitous but unread card warning bulletins that are issued by our licensing agents.

These kinds of developments, I think, will do essentially two things: It will speed up collection of funds, and provide quicker deposit and less float to the merchant; and second, will provide in a less risky way, a more assured way of processing payments across the future. Of the 80 million ATM cards being used in the United States today, a greater and greater portion of those will be used for the acquisition of goods and services, not just the acquisition of cash from automated tellers.

I think that is the kind of development, Senator, that you can expect.

Senator HECHT. Let's get on to banks, now. I have also been in banking for 20 years. Small banks could not survive today without the technology development of big banks. Roughly 14,500 commercial banks. I don't know what percentage would not be available today. The minute you start getting into that, you are able to cut your costs down considerably.

BANKING TECHNOLOGY FUTURE CHANGES

What do you see in banking technology changes in the next 10 years?

Mr. HEFNER. That's a rather broad question. I think as it relates to the ability of the smaller institution to succeed, and to be a part of the emerging payments mechanism, the fact that the banking community is highly fragmented and has that many members of varying sizes represents a market opportunity in itself.

Certainly members of ADAPSO are among those who provide services to smaller banks and bring the power of technology to those who literally don't have the entrepreneurial power to do it themselves. I would think that those kinds of services available to virtually any financial institution, not only will they be available but they will be available in ways in which the transfer of the money will be faster, will be more convenient, and in all likelihood will extend beyond the traditional delivery mechanisms we see today, not only being able to get money at virtually any office or for any point-of-sale device, but also in the home as well, and I think that the market is likely to be essentially two sets.

One is a set of perhaps larger players who have both the corporate will and the entrepreneurial spirit to build systems and deliver them directly. The other will be those corporations who decide to provide services on behalf of the smaller institutions, and actually sell services on behalf of those institutions to their customers.

Senator HECHT. Certainly nothing has done more to promote free enterprise than what you have just talked about. What do you think the Government should do to encourage this in the next few years? What should our role be?

Mr. HEFNER. I believe the principal role that I think the association would like to see relative to the Congress is really to tread very cautiously in dealing with legislation that has to do with technology.

I guess one of the examples I would use is our view of the EFT Act and the subsequent regulations. At the time the EFT Act was being considered, there were some very laudable goals in terms of being able to protect consumers, in terms of their liability, and that concern that Congress had—which certainly was legitimate—translated itself into very detailed information about the kinds of documents that consumers would have to receive in order to legitimatize electronic funds transfer.

Subsequent to that act and its consideration in Congress, a new set of electronic services called home terminals was then created. And if the Fed, the Federal Reserve Board, in its interpretation of regulation E had not taken a liberal view, it would have been necessary for those who are deplying home terminals services to have a printer available in every home. That could have seriously delayed the implementation of some of those experiments, and perhaps precluded it.

By simply having the Fed taking a liberal view and say, well, it is not necessary to have printed receipts for those transactions since you are displaying information on a television screen and the use of the terminal is the same as using a telephone, those experiments were allowed to proceed much to the benefit of consumers and financial service providers conjointly.

If the Fed had not taken that role, literally thousands of terminals would have to have been removed from homes because of the inability of the system to stand the application of a printer into that environment.

And, I think when Congress deals with things that can impact the ability of the technology to be applied to a business problem that it runs a very risk of impeding progress rather than helping it, and we would hope that as Congress looks at those kinds of issues, that they look more at the goal and express very succinctly the kinds of things that they would hope would protect consumers or protect the various business agencies without getting into the very detailed kind of legislation that the EFT Act promulgated.

Senator HECHT. Thank you very much. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Lautenberg.

Senator LAUTENBERG. Thanks, Mr. Chairman. I am sorry that I missed so much of the hearing this morning because I have a very active interest in what is taking place here.

The first time that I ever visited a Hall of Congress I sat someplace near where Mr. Nugent is sitting. I was then president of ADAPSO, which is the Association of Data Processing Service Organizations, and I was then pleading with the Congress to keep banks out.

It is kind of nostalgic for me in looking back finally at my civilian days, but we were then pleading the case for the banks to stay out of the payroll business because we thought that it was not really, in the purest sense, incidental to the financial services.

What we couldn't accomplish legislatively we accomplished in the marketplace. We knocked their ears back, the computer services business, because we were able to do this thing so much better.

It was not uneconomic to the banks to engage in this business, as you can see by recent experience.

My good friend Senator Hecht from Nevada gave too much credit to the large banks for development of this technology. Mr. Hefner was quick to note that it was members of the service organizations that promoted some of the technology that made it easier for the small banks to function, and I think we ought to continue to promote that entrepreneurship.

Senator Garn and I share a belief that the entrepreneur is the salvation of much of our economic system and affords the opportunity to do all kinds of things that we could never accomplish, either by social systems or other things, even though we are in different parties and perhaps even different positions in those parties.

But the thing I am concerned about, besides my speech this morning, is what is happening without any jurisdictional review by the Congress in terms of access to credit and capital for various sectors of the economy—and this has now become a rather, I think, boring theme for other members of the committee. But I am concerned about what happens to the consumer, as I define him, the small businessman, the small business person, the individual who goes to the bank to borrow money in order to finance his enterprise. Are those kind of services still going to be available?

I rather doubt it. I think they will fall out of the general banking area and fall more and more to the finance companies. Individuals and small firms will be competing with borrowers all over the country who suddenly have access to pool capital through either interstate banks or other kinds of associations.

Now, Mr. Hefner, you said something in your statement here I just quickly reviewed, and I am a little unclear as to what exactly you are saying.

INTERSTATE EFT OPERATIONS GROWING

You say, "Interstate EFT operations exist today and are growing, despite legislative hurdles and the absence of modern day congressional input. In our opinion, it would be wise for Congress to directly address the expansion of banking and the new realities of the financial industry."

It sounds like a contradictory statement. In the first sentence you say "exists today and are growing despite legislative hurdles." In the next sentence yoy say, "For Congress to directly address the geographical expansion."

What exactly are we talking about here?

Mr. HEFNER. The context of the remark, Senator, was to look at the ambiguity of existing State law as it relates to the ability of consumers to access their accounts through terminals deployed by institutions and other States.

It was meant to create a framework for the subsequent discussion of our proposal for the EFT Interchange Act, wherein we think that there are ambiguities, that there is some uncertainty, because many of these State laws were passed at a time when, frankly, the current technology wasn't even contemplated.

We would propose that the Interchange Act that we are discussing this morning would provide a base level of legal certainty for what in fact is occurring in many parts of the country where, because of the entrepreneurial spirit of those who are building the system and their ability to accept risk that may in fact involve some of that legal uncertainty, they have nonetheless gone ahead and provided it for their customers.

Senator LAUTENBERG. I have got a question for you, Mr. Hefner, that may be coincidentally affecting two areas of interest that I have. One is in the general communications area and the other the financial services industry.

Have you looked at the subject of access to TV channels, cable TV in particular, in terms of the availability of channels for bank services?

Mr. HEFNER. We have people who have looked at it. I am not that familiar with it, Senator, frankly.

Senator LAUTENBERG. I just wondered whether you could comment as to whether there is enough access as far as the industry is concerned.

But in terms of the cable legislation that is contemplated right now, one of the complaints I have heard is that the financial institutions may be barred from access on these channels unless it is provided for in the legislation someplace.

I wonder if you have anything to offer on this.

Mr. HEFNER. Without being familiar specifically with the legislation, at the present time many of those people who are providing home financial services are doing so across common voice grade telephone lines, which are, as everyone knows, rather slow, and I suppose some could even say somewhat less secure.

I think any legislation that precluded free entry of financial service providers to provide for the transmission and acceptance of information from a home or office would probably be not in the best interests of the technology itself.

There may be people within EFTA—and frankly I have not looked at this—who would disagree with that statement. So I am speaking now personally.

Senator LAUTENBERG. Mr. Nugent, you are representing ADAPSO here, and I am sorry, again, I wasn't here to hear your testimony or the testimony of all of you. I will be reviewing it in detail, I promise you.

Is there anything—what, in sum, if you can, is the general position? Are we back kind of asking that the banks don't get into general data processing services unrelated to banking.

Mr. NUGENT. Our position has changed somewhat since those days when we were talking about payroll. Now when we talk about the problem, we assert that you have got to define what "data processing" is and look at the services to be provided through the technology rather than the technology itself.

The question here does not involve technology. The question involves the nature of the permissible services to be offered through data processing technology. We have stated that financial data processing services may well be permissible, but we want to take a look at those and see which ones are permissible.

We have also said that purely economic data processing services or general purpose services, such as computer timesharing services, have a lot of danger to them in that they involve the provider in purely commercial activities that are far afield from banking. We have asserted that the wall between banking and commerce should be preserved.

We have continued since the sixties our view that the data processing activities of banks, AT&T, and CPA's, where engaged in the competitive marketplace, should be provided only through a subsidiary which is separated from the depository institution itself and proposed six principles for separation. This separate-subsidiary approach provides a mechanism—it is not failsafe—but a mechanism to identify and minimize and maybe even nullify the opportunities that are provided by affiliation of a competitive entity with a regulated entity.

Senator LAUTENBERG. Being realistic, so many of these services are being presently offered by banks throughout the country. As we approach further and further deregulation in our society, is it realistic to think that we can ask that they—the banking industry, the financial service industry today—be excluded from these kinds of opportunities?

It may serve the interests of the members of your association and it may serve the computer services industry generally to have it, but we are at a point now where these services have been offered for so long that I wonder whether we are being realistic if we think that we can ask that those services be excluded from banking.

Mr. NUGENT. Senator, we believe so. This has been a very divisive issue within ADAPSO. Banks are members of ADAPSO, and it has been a very troublesome issue.

There has been much concern, as we get into the bundling of data, communications, and computing, that there are dangers with bank control of debiting and crediting, which, as you well know, is essential to the performance of data processing services; also, bank control of account information, which, as you know, is essential to the performance of data processing services. And the home banking example is a good one.

Surveys have shown that the offering of a debit or credit service is critical to the success of a home-banking or home-terminal-based offering.

If banks are able to offer that aspect of the package plus everything else, why go with an independent data processor?

That is one aspect of the problem that we are very concerned with—the rebundling that is going on—which may preclude entities such as EDS, ADP, and others to provide only one aspect of the overall package, which is the communications or the computing and not the bank data which is becoming a bottleneck in our area.

Senator LAUTENBERG. Mr. Chairman, I have run out of time. May I take a minute more?

The CHAIRMAN. We have no additional questions, so sure.

Senator LAUTENBERG. Thank you very much.

I just wanted to express a viewpoint again. Perhaps it is instinctive, but I try to be objective about my views on this.

That is that banking or the financial services—and I am going to use the Board's definition—has a special place in our society.

I am concerned about the extension of services, not because I don't want to see an additional opportunity for financial institutions or any kind of institutions that want to get into the business. I don't have a problem, very frankly, with so-called nonbanks getting into banking.

I have a problem, however, when I see banking industry, looking to extend its range of services while seeking to exclude these other nonbank folks and keep them from getting into the business.

One thing that I would like to be sure of, if we can get that kind of assurance, and that is that the banking services that were so essential to the small business development, to the individual consumer will still be available. And I am concerned as we expand the range of services—more than I am, very frankly, with the nonbanking enterprise getting into the banking field—that we will be siphoning off capital funds that are clearly scarce right now and concentrating those into the hands of the giant borrowers or into the large money centers and not having it available to the public at large.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you very much, gentlemen. We appreciate your testimony today.

We have a second panel to come before the Banking Committee today.

We're happy to have before us today, a second panel, Mr. Glenn Nishimura, legislative representative of the Consumer Federation of America, and Mr. James M. Hacking, assistant legislative counsel, American Association of Retired Persons.

Mr. Nishimura, would you like to begin, please.

STATEMENT OF GLENN NISHIMURA, LEGISLATIVE REPRESENTATIVE, CONSUMER FEDERATION OF AMERICA, WASHINGTON, D.C.

Mr. NISHIMURA. Thank you, Mr. Chairman, and Senators. I am Glenn Nishimura, legislative representative of the Consumer Federation of America. CFA is pleased to have the opportunity to address this committee on changes that are occurring and will occur in the financial services industry. It is a topic that has a dramatic and far-reaching impact on consumers.

I'd like to take this opportunity to summarize and expand on my written testimony.

Deregulation of the financial services industry is happening at its own rapid pace, a pace only limited by the ingenuity of those seeking to circumvent Federal oversight and regulation without breaking the law. CFA believes that this is an unhealthy process.

Congress has a legitimate responsibility to promote stability in the financial marketplace. In meeting that responsibility, Congress should identify and thwart actions that undermine the ability of the Federal Government to achieve established social and economic goals and priorities. State action may be justified, when the consequence of those actions remain within the borders of that State, but it is an altogether different proposition to allow State actions that undermine Federal law which was enacted to assure market stability.

While Congress has not been adept at keeping step with the rapidly changing industry, that lack of timeliness should not justify a carte blanche attitude toward decontrol. Should economic condition call for a change in the law, Congress should be the body that allows those changes to occur.

WHOLESALE DEREGULATION THREATENS CONSUMER PROTECTION LAWS

I should mention at this point that we see some advantages for consumers under decontrol of financial institutions, but we are particularly concerned about the threat that financial decontrol poses to a wide variety of consumer protection laws enacted by the Congress. To respond to reported abuses in the marketplace and to assure that lenders would pay appropriate attention to categories of borrowers that were traditionally neglected, Congress passed an impressive array of consumer-minded legislation. Wholesale deregulation of the financial markets threatens to dismantle those consumer protection laws.

For an example, let's consider the Home Mortgage Disclosure Act and the Community Reinvestment Act. They were enacted by Congress to curb neighborhood disinvestment and make depository institutions responsive to the communities in which they operate. Research by consumers had indicated that deposits from residents of older neighborhoods were being used to fund borrowers in suburbs or were being exported to other markets, siphoning off capital from these older areas and contributing to neighborhood deterioration.

Under deregulation, the priorities embodied in HMDA and CRA are jeopardized. Decontrol of deposit interest rates, places increased pressure on lenders to maximize profits, regardless of the proximity of profit opportunities. Interstate banking raises the possibility that decisions affecting the reinvestment of funds into communities will be made in another State or even another region. Diversification of the thrift industry and bank expansion into nonbank activities may further reduce funds to neighborhoods.

Depository institutions must compete with entities that may not have any community base. And those institutions quite justifiably, we think, might feel that HMDA and CRA place them at an competitive disadvantage. Such a situation would provoke from them cries for a "level playing field" and abandonment of consumer protection laws like HMDA and CRA.

But there are other possible responses. HMDA and CRA could be expanded to include other players in the market or a new mechanism could be devised to provide investment funds to communities. But the important point here is that Congress passed these laws because neighborhoods were starved for capital. Rejections of loans on the grounds that neighborhood deterioration made such loans risky became self-fulfilling prophecies. This neglect by lending institutions evolved in an environment far less aggressive than the environment we see today. And there is no reason to believe that under the deregulation agenda, community needs will be met.

TRUTH-IN-SAVINGS LEGISLATION

Enactment of HMDA and CRA represented the establishment by Congress of a social and economic policy, a policy just as necessary today, and it should not be abandoned in a fit of deregulatory zeal. Likewise, Congress should preserve and extend consumer laws designed to assure fairness and equity in the conduct of credit transactions. Adequate information being a necessary element of a truly competitive environment, truth-in-lending should be supplemented with truth-in-savings legislation. Truth-in-lending, itself, I would interject, is suffering under the deregulatory environment, because it is losing its effectiveness. It was designed to operate in a market where there were fixed-rate mortgages and where there were closed-end transactions. And the adjustable rate features of deregulation that we are seeing now are making the terms of truth-in-lending less appropriate and less effective for consumers. So that needs strengthening there.

But the need for truth-in-savings legislation is based on the emergence of diverse array of savings mechanisms in the marketplace. Consumers could benefit by the many choices that they see, if they have the information that would allow them to compare their options. CFA supports enactments of truth-in-savings legislation that would require full and readable disclosure of essential contract terms and conditions. Interest rates paid on such accounts should be calculated using a standard methodology.

CFA believes that banks do serve a unique funcion, and that that uniqueness may warrant special considerations. It is in the national interest to have institutions where consumers can be confident that deposits are safe, to have a system that the Federal Government can use to encourage reinvestment of deposits in the local economy or to achieve other social or economic priorities and to have an efficient payment system and a network through which monetary policy can be conducted. Institutions that respond to those needs may deserve special privileges in exchange for agreeing to special restrictions.

Without going to the merits and demerits of deregulation of telecommunications, that process can serve as an example. The part that was deregulated was that part which Congress or which Justice and other appropriate bodies felt were competitive, but they also recognized that there was a certain need for some organizations that provided telephone service to the local community, and they kept those under regulation.

And I believe that might be an appropriate approach for Congress to take. Congress should not allow any further deregulation of financial institutions without assessing probable outcomes and considering consumer impacts. Objectives should be stated, fair and equal treatment of consumers preserved, and an orderly approach to deregulation should be drafted. Otherwise, deregulation of our financial markets could benefit few, harm many and create a counterraction that would be heard from Main Street to Wall Street.

Thank you.

[The complete statement follows:]

TESTIMONY BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

BY

GLENN NISHIMURA
LEGISLATIVE REPRESENTATIVE
CONSUMER FEDERATION OF AMERICA

REGARDING
DEREGULATION IN THE FINANCIAL SERVICES INDUSTRY

JUNE 9, 1983

I am Glenn Nishimura, Legislative Representative for the Consumer Federation of America. CFA is pleased to have the opportunity to address this committee on changes that are occurring and will occur in the financial services industry. It is a topic that has a dramatic and far-reaching impact on consumers.

Deregulation is happening at its own rapid pace--a pace only limited by the ingenuity of those seeking to circumvent federal oversight and regulation. For example, federal prohibition of interstate banking is being undercut by an increasing number of state bills proposing to permit out-of-state banking within their borders. And, despite a federally mandated separation of commercial and investment banking, a loophole in the law has allowed non-banks to get into the deposit-taking business without falling under the Bank Holding Company Act. Moreover, states such as South Dakota are amending their laws to allow state-chartered banks to engage in all aspects of the insurance business, further eroding the separation of banking powers.

CFA believes that this is an unhealthy process. Congress has a legitimate responsibility to promote stability in the financial marketplace. In meeting that responsibility, Congress should identify and thwart actions that undermine the ability of the federal government to achieve established economic and social priorities. State action may be justified when the consequences of those actions remain within the borders of that state. But, it is an altogether different proposition to allow state actions that undermine a federal law which was enacted to insure market stability. And while Congress has not been adept at keeping step with the rapidly changing industry, that lack of timeliness should not justify a carte blanche attitude toward decontrol. Should economic conditions call for a change in laws, Congress should be the body that allows those changes to occur.

CFA is particularly concerned about the threat that financial decontrol poses to the wide variety of consumer protection laws enacted by Congress. To respond to reported abuses in the marketplace and to assure that lenders would pay appropriate attention to categories of borrowers that were traditionally neglected, Congress passed an impressive array of consumer-minded legislation. These included the Truth-in-Lending Act, Equal Credit Opportunity Act, Real Estate Settlements Practices Act, Fair Credit Billing Act, the Fair Debt Collection Practices Act, Home Mortgage Disclosure Act and the Community Reinvestment Act.

Wholesale deregulation of the financial market threatens to dismantle those consumer protection laws. For example, consider the Home Mortgage Disclosure Act (HMDA) and the Community Reinvestment Act (CRA). HMDA and CRA were enacted by Congress to curb neighborhood disinvestment and make depository institutions reponsive to the communities in which they operate. HMDA requires depositories to report on the geographic distribution of their mortgage and home improvement loans. Research by consumers had indicated that deposits from residents of older neighborhoods were being used to fund borrowers in suburbs or were being exported to other markets, siphoning off capital from these older areas and contributing to neighborhood deterioration. The filings provided under HMDA enabled local groups to determine the geographic patterns of credit provided by local lenders.

Like HMDA, the CRA equips community residents and small businessmen with the ability to hold financial institutions accountable to the local area. By encouraging financial institutions to extend credit to all parts of their local service area, the CRA recognizes that depository institutions have a responsibility to meet the credit needs of their communities.

However, under deregulation, the priorities embodied in HMDA and CRA are jeopardized. Decontrol of deposit interest rates places increased pressure on lenders to maximize profits, regardless of the proximity of profit opportunities. Interstate banking raises the possibility that decisions affecting the reinvestment of funds into communities will be made in another state or even another region. Diversification of the thrift industry and bank expansion into non-bank activities may further reduce funds to neighborhoods.

Depository institutions must compete with entities that may not have any community base. Those institutions would justifiably feel that HMDA and CRA place them at a competitive disadvantage. Such a situation would provoke cries for a "level playing field" and abandonment of HMDA and CRA. But, there are other possible responses. HMDA and CRA could be expanded to include other players in the market. Or, a new mechanism could be devised to provide investment funds to communities.

Congress must remember that these laws came into effect because neighborhoods were starved for capital. Rejections of loans on the ground that neighborhood deterioration made such loans risky became self-fulfilling prophesies. This neglect by lending institutions evolved in an environment far less aggressive than the one we are experiencing today. There is no reason to believe that under the deregulation agenda, community needs will be met. The enactment of HMDA and CRA represented the establishment of a social and economic policy. That policy is just as necessary today and should not be abandoned in a fit of deregulatory zeal.

Likewise, Congress should preserve and extend consumer laws designed to assure fairness and equity in the conduct of credit transactions. Adequate information being a necessary element of a truly competitive environment, Truth-in-Lending should be supplemented with Truth-in-Savings legislation.

The need for Truth-in-Savings legislation is based on the emergence of a diverse array of savings mechanisms in an ever-growing financial market. Consumers could benefit by so many choices if they had the information that would allow them to compare options. CFA supports enactments of Truth-in-Savings legislation that would require full and readable disclosure of essential contract terms and conditions. Interest rates paid on such accounts should be calculated using a standard methodology.

CFA believes that banks do serve a unique function, and that that uniqueness may warrant special considerations. It is in the national interest to have institutions where consumers can be confident that deposits are safe. It is in the national interest to have a system that the federal governement can use to encourage reinvestment of deposits in the local economy or to achieve other social or economic priorities. It is in the national interest to have an efficient payment system and a network through which monetary policy can be conducted. Institutions that respond to those needs may deserve special privileges in exchange for agreeing to special restrictions.

Congress should not allow further deregulation of financial institutions without assessing probable outcomes and considering consumer impacts. Objectives should be stated, fair and equal treatment of consumers preserved, and an orderly approach to deregulation should be drafted. Otherwise, deregulation of our financial markets could benefit few, harm many and create a counter reaction that would be heard from Wall Street to Main Street.

The CHAIRMAN. Thank you, Mr. Nishimura. Mr. Hacking.

JAMES M. HACKING, ASSISTANT LEGISLATIVE COUNSEL, AMERICAN ASSOCIATION OF RETIRED PERSONS, WASHINGTON, D.C.

Mr. HACKING. Thank you, Mr. Chairman.

On my left and accompanying me is Robert Brunner, who is one of our legislative representatives. On my right is Mr. Ralph Borsodi who is one of our economic consultants.

We are here representing the American Association of Retired Persons, which now has a membership of 14 million persons aged 50 and older. We sent two documents to the committee, and I ask that they both be included for the record. But I would like to base my summary——

The CHAIRMAN. Did you say 50 or older?

Mr. HACKING. Fifty or older.

The CHAIRMAN. When did they get down to 50?

Mr. HACKING. When our board of directors met earlier this year, they decided to lower the age to 50.

Senator LAUTENBERG. Am I glad I am not in that category. [Laughter.]

The CHAIRMAN. I turned 50 my last birthday, and I am not even in my prime yet. [Laughter.]

I have a child that will be 1 year old on Monday. What is this down to 50 business? Do I get cards for cut rates at movies and things like that now?

Mr. HACKING. Of course, the association is offering a rather wide range of services——

[Laughter.]

Mr. HACKING [continuing]. For our members.

The CHAIRMAN. I am really devastated. [Laughter.]

I may cut this hearing short and go buy a toupee. [Laughter.]

Please continue. I'm sorry.

Mr. HACKING. Thank you.

FINANCIAL SUPERMARKETS

While I would add that both of the documents that we sent to the committee should be included in the record, I would like to base my summary on the more comprehensive, supplemental statement. The elderly use every financial service that is being offered today by the so-called financial supermarkets. They buy and sell real estate. They buy every kind of insurance. The buy and sell equities and fixed securities. And they seek safe and rewarding depositories for that portion of their assets they wish to hold in cash. The banking system, the stability of the value of money, savings facilities and deposit insurance are, therefore, of great concern to the elderly, collectively.

The basic point of our presentation is that the Federal Government should not stand in the way of changing financial institutions. However, since the implementation of the monetary policy of the Federal Government is primarily exercised through commercial banks or financial institutions by any other name that can create deposit money, they cannot escape rigorous surveillance in the public interest.

The financial institutions must adapt themselves to the changing scene, if they are to serve efficiently the needs of the population.

AARP has long been an advocate of deregulating financial institutions, so the marketplace can shape the services it offers and so that competition can bring down the cost of these services. AARP has been fighting for the elimination of interest ceilings on small depositors' accounts for the better part of a decade. These interest ceilings not only disadvantage small savings depositors while subsidizing the construction industry and mortgage borrowers, but also, combined with other Government regulations, can imperil the financial stability of large numbers of savings and loans and mutual savings banks.

Although these hearings ask for advice on how financial institutions should be structured, AARP's best counsel is that the Government should withdraw from the activity of determining what lines of business variously labeled financial institutions should engage in and determining how these businesses should be specifically conducted.

In advocating that the Government cease this kind of planning, AARP does not propose that the Government abrogate its responsibility for providing safe vehicles to small savings depositors, nor do we propose that the Government fail to keep close control over the creation of deposit money. In an era of managed paper money, retaining control over the money supply must remain a preoccupation of the Government.

Financial institutions have been reshaping themselves during the early eighties. In fact, there is a revolution going on. The clear lines that once separated banking, brokerage and insurance and financial from nonfinancial companies have rapidly been fading away. The small, highly regulated, specialized financial institutions are well on the way out, to be superseded by widely diversified financial giants, loosely regulated and operating in a large number of different businesses with the common thread of money.

Certainly, financial institutions' innovations are needed to accommodate the major changes taking place in our society. But there are continuing general welfare elements inherent in the regulation of important aspects of the activities of financial institutions. These general welfare elements we would categorize as follows:

First, financial institutions which are collectively able to create deposit money must be circumscribed in their activities;

Second, savings, both large and small, need to be encouraged. A movement to larger and larger financial institutions or financial conglomerates may not be conducive to promoting small, or what we would call "mass" savings;

Third, the guarantee of small savings deposits is conducted in a way which enables Federal financial institutions to trade on the implicit capital provided by the Government;

Fourth, although bigness is not necessarily bad, the movement to bigness in financial institutions raises serious questions as to whether or not any antitrust activity of importance can be taking place in the financial sector.

Finally, banking, both in the private sector and the central bank is from time to time much involved in inflationary activity. Although the recent recession substantially reduced the inflation rate, restraints on inflation should not be imposed on a stop-and-go basis as they have been in the past.

Let me enlarge on some of these points.

Banking has been undergoing redefinition by the Federal Government, as an activity conducted by any financial institution providing deposit facilities which can be "checked" upon. Behind this definition has been an intention to impose noninterest bearing reserves on financial institutions engaged in bank-like activities, so that the various types of financial institutions are more or less competitively equal, to the extent of having a portion of their capital tied up in noninterest earning reserves in the Federal Reserve System.

We think it is wrong to impose fractional reserves as an equalizing tax. This subverts the primary purpose of fractional reserves which, in our view, is to control the creation of deposit money. In addition, riskier forms of financial institution business activities, such as underwriting securities, developing real estate, underwriting property, casualty and life insurance should, we think, be insulated from the ordinary activities of commercial banking operations. Banking and commerce should not be mixed.

SMALL SAVINGS ACCOUNTS MAY BE NEGLECTED

AARP encourages the activities of financial institution in extending savings facilities to locations which not only serve the elderly but small savers everywhere. The move to larger conglomerate financial institutions raises some concern that small savings accounts may be neglected in favor of more profitable lines of activity. Small savings accounts are guaranteed by the Federal Government, so the depositor is secure even though the financial institution offering the facilities might engage in lending activities or in business activities of an innovative nature, as opposed to traditional, less risky operations.

We do not see any objections to innovative activities, providing appropriate capital requirements are met or appropriate reserves are set aside by mutual institutions. If the innovative activities raise the operating risks, the premiums for Government deposit insurance should be appropriately raised.

In response to section 712 of the Depository Institutions Act of last year, the FDIC and the Federal Home Loan Bank Board have now responded with studies that recommend variable deposit insurance premiums, so the inequity of charging the same premium for deposit insurance without regard to the character of the operations of the insured institution would be removed, or removed at least in part. We endorse that recommendation.

That concludes my presentation, Mr. Chairman. I thank you for having had this opportunity to present it.

[The complete statement follows:]

SUPPLEMENTAL
STATEMENT

of the

AMERICAN ASSOCIATION OF RETIRED PERSONS

on

THE CURRENT STATUS AND FUTURE DIRECTION OF THE FINANCIAL SERVICES INDUSTRY

INDEX

I. Introduction

II. The Need for Innovative Financial Institutions

III. Innovative Developments in Financial Institutions (early 1980s)

IV. Recommendations

- Commercial Banking
- Savings Type of Financial Institutions
- Deposit Insurance

V. Summary Remarks

Introduction

We thank the Chairman on behalf of some 14 million members of the American Association of Retired Persons for the opportunity to testify before the Committee on new directions for the financial services industry. The elderly, and those who are preparing for retirement, have a keen interest in annuities and pensions. The elderly use every financial service being offered by so-called financial supermarkets. They buy and sell real estate, they buy every kind of insurance, they buy and sell equities and fixed securities, and they seek safe and rewarding depositories for the portion of their savings they wish to hold in cash.

The banking system, the stability of money, and savings facilities are of keen concern to the elderly. Deposit insurance usually ensures that elderly depositors receive the dollar back, which they placed on deposit. However, the trend to rising and persistent inflation, which commenced in the mid-1960s, caused great losses to the elderly, much of whose assets were financial. These financial assets commenced to decline in purchasing power, as inflation rates advanced. This phenomenon is a most elementary observation of what takes place when inflation gets out of hand. Nevertheless, there are some who chose to deny that the inflationary binge during the 1970s harmed the elderly.

The facts are the insecurities of our monetary system contributed in so small way to an income situation for the elderly, which can be rightly characterized as precarious. Consider a few statistics:

- Older Americans experience the highest poverty rate (15.3%) of any adult age group and one of the highest near-poverty rates (25.2%), with older women predominating in these categories.
- Median income levels of elderly-headed households are only one-half that of their younger counterparts.
- Elderly households are overwhelmingly concentrated in the lower income brackets -- 21% of them have annual incomes below $5,000 and over 50% have incomes below $10,000.

The basic inflation rate is at least half of what it was three years ago. Indeed, there is much opinion that the inflation rate is permanently under control -- seemingly cured by a deeper than normal recession. The facts are that the forces and institutions, which have contributed to inflation, are still with us -- and waiting for us to let our guard down.

The basic thesis of this testimony is that the federal government should not stand in the way of changing financial institutions. However, commercial banks, or a financial institution by any other name, which can create deposit money, have special powers which make them very much tied to the public welfare. The monetary policy of the federal government is primarily exercised through commercial banks, who cannot escape rigorous surveillance in the public interest.

The Need for Innovative Financial Institutions

United States is in the midst of simultaneous revolutions in technology, race, religion, economics, education, politics, communications and social relations. Waves of change have repeatedly washed over America dating back to its founding. However, the tempo of these changes seems to be rising.

Time Magazine on May 30th quoted Governor Pierre du Pont IV of Delaware in a pertinent statement: "The transformation of our jobs, the movement of our people, the improvement in our skills over the first eighty years of this century have been stunning. But it is entirely likely that those changes will be matched and exceeded during the final 20 years of the century."

The banking world has sensed these changes. Walter B. Wriston, Chairman of the Board of Citicorp (National City Bank) spoke of the transformations taking place and of their significance for the banking industry in the New York Times Magazine, May 29, 1983:

> "The world, he said, is in the midst of a great transformation, comparable to those of the Renaissance and the Industrial Revolution. Rapid technological advances, especially in finance and communications, are drastically reducing the work force in heavy industry. Meanwhile, demand grows for more sophisticated workers in such service industries as finance and communications. Distinctions between businesses are becoming blurred.

> In such an atmosphere, he said, banking must have broader goals. Bankers must consider all of the financial needs of their customers, not just deposits and withdrawals. The movement of money today simply requires some split-second electronic instructions to shift funds from one account to another. That, Wriston decided, makes banking part of the communications business."

Our business institutions, including financial institutions, must adapt themselves to the changing scene, if they are to efficiently serve the needs of the population. AARP has long been an advocate of deregulating financial institutions, so that the marketplace can shape the services they offer, and so that competation can bring down the costs of these services.

AARP has been fighting for the elimination of interest ceilings on small depositors accounts for the better part of a decade. These interest ceilings not only disadvantaged small savings depositors, including elderly depositors, while serving to subsidize the construction industry and mortgage borrowers, but also combined with other government regulations to imperil the financial stability of large numbers of savings and loans and mutual savings banks. Well intentioned government controls lingered on during an unforseen inflationary cycle, with crippling e[illegible]s on the "thrift" industry.

Although these hearings ask for advice on how financial institutions should be structured, AARP's best counsel is that the government should withdraw from the two activities of 1) determining what lines of business variously labeled financial institutions should engage in; and 2) determining how this business should be specifically conducted. Only the marketplace can shape these structures efficiently.

In advocating that the government cease this kind of planning, AARP does not propose that the government abrogate its responsibility for providing safe vehicles for small savings depositors. Indeed, if the United States is to restore good savings habits, savings facilities -- paying market rates of interest -- should be greatly expanded. AARP does not propose, also, that the government fail to keep close control on the creation and extinguishment of deposit money -- the bulk of the money in use today. In an era of managed paper money this must be a preoccupation of the government authorities, sharing responsibilities for the money supply.

Innovative Developments in Financial Institutions (early 1980s)

Financial institutions have been reshaping themselves during the early 1980s, both by straining the bounds of their regulatory limits and by altering their regulatory "cages", through lobbying for new business parameters, some of which have been incorporated in new monetary legislation. We briefly review some of these innovative developments during the first years of the 1980s:

Installment car financing corporations have diversified from consumer lending into leveraged leasing, real estate loans, mortgage insurance and life insurance.

Life insurance companies have been allowed to merge and to offer new products because fixed investments under a long-term inflationary trend have become unpopular (such as whole life policies). Single premium deferred annuities have become popular. A new product is universal and variable life, which gives the customer cheaper rates, a near-market rate of return, flexibility in coverage, and frequent payments. Insurance companies have been acquiring brokerage firms in order to expand their financial services.

New fixed-income instruments have been brought into the market. One is called a Treasury Investment Growth Receipt (TIGR). It is backed by U.S. Treasury Bonds. The receipt pays no current interest. It is sold at a discount from the amount of either the interest or the principal payment, which secures it. When the interest or principal payment becomes due, the holder of the receipt gets his money.

Bank holding companies have acquired discount brokerage services with the approval of the Comptroller of the Currency. A group of 28 S & L's organized a stock-brokerage network with the idea of offering the brokerage services through a network of 1000 offices around the country. The Securities and Exchange Commission ruled that the proposal did not violate federal banking law.

Banks and S & L's, concerned about the growth of Money Market Funds ($200 billion as of 6/28/82), propose new savings accounts to compete, but remain concerned that the new accounts might "cannibalize" savings from passbook savings accounts, which pay only 5¼ and 5½ percent interest. (The first competing certificate was a six-month money market certificate, available since June 1, 1978 with a $10,000 minimum.) A recent addition was a three-month money market certificate, available May 1, 1982, with a $7500 minimum. (Both certificates had interest rates tied to Treasury Bills.) Since passbook savings accounts totaled some $275 billion it was feared by banks and S & L's that even a small switch into new, low minimum, deposit accounts would excessively increase their costs.

The clear lines that once separated banking, brokerage and insurance and that once separated financial from nonfinancial companies have faded away. The day of the small, highly specialized, tightly regulated financial institution seems to be well on the way out, to be superseded by widely diversified financial giants, loosely regulated, and operating in a large number of different businesses with the common thread of money.

The "1980 Financial Institutions Deregulation and Monetary Control" Act was passed, deregulating and expanding the powers of financial "depository" institutions so that some 40,000 of them, including commercial banks, savings banks, saving-and-loan associations and credit unions could offer similar services, pay similar rates on deposits, and all use the Federal Reserve System. (The Act was deregulating in the sense that various financial institutions were granted similar operating powers, but regulating in that large numbers os financial institutions became subject to Federal Reserve System rules.)

At the beginning of the 1980s many forecast the emergence of a national banking system, dominated by big banks, brokerage firms, insurance companies and retailers. The new competition was weakening the smaller, unit banks which sought protection by merging. The number of bank holding companies has steadily grown. The community banks and regional banks have been weakened by brokerage firms, credit-card companies, insurers and other nondepository institutions - all of which offer "banking" services, without geographic restrictions. Smaller banks lack the expertise to deal with volatile interest rates and lack the ability to raise additional equity, as their competitive position deteriorates.

In 1982 nationwide banking was expected to arrive through the back door by customers of many leading banks, who would be able to use their bank cards at interlinked, automatic teller machines (AIMs) across America.

In 1982 banks from coast to coast began to experiment with electronic home banking, which was thought to be a way around the ban on interstate banking, laid down by the McFadden Act of 1927.

In 1982 "Sweep Accounts" began to be used by financial institutions in order to combine interest bearing checking account, with a money market fund. Amounts above a minimum deposit requirement are swept by a computer every night into a high interest rate paying money market fund. When account balances fall below the minimum deposit requirement, a reverse movement of funds would take place.

International banking facilities were established in "free trade zones" in American cities in late 1981. The effect was to transfer the U.S. banks' share of the Eurocurrency market to the U.S. free trade zones.

The Depository Institutions Act of 1982 provided new assistance for the "thrifts" in the form of short-range, noncash assistance in the form of government promissory notes.

Mid-year 1982 saw expanded discount stock brokerage services become available at many banks, as promoted by large discount brokerage houses.

Mid-year 1982 the Comptroller of Currency predicted that community banks would find that the net spread between interest earned and interest paid-out would continue to shrink; therefore they must both contain their operating costs and find new sources of income.

By August, 1982 money market mutual funds had grown to some $220 billion, all invested in short-term money market instruments - Treasury Bills, short term coupon Treasuries, discount agency notes, repurchase agreements, commercial paper, certificates of deposit, bankers acceptances, Euro-CDs and Yankee-CDs.

Since November 1, 1982 the Treasury began issuing a new Series EE Savings Bond that would pay at market rates, if held at least for 5 years. These bonds are exempt from state and local taxes, and earnings can be deferred from income tax until cashed in.

In early 1983 Treasury Secretary Donald T. Regan predicted that the distinctions between financial institutions would continue to blur in the coming decade until, in the 1990s "you will have banks, insurance companies, investment banking and brokerage firms - and even piano companies - that begin to look more and more alike."

In mid-year 1982 a Federal Reserve System program of planned disinflation came to an end. This program dated back to October, 1979. This program, with much support from both Presidents Carter and Reagan, had halved basic inflation rates over 3 years, but at the costs of recession and high unemployment. The pains of disflation did not deter many from advocating another round of "stop-and-go" policies on containing inflation, as both fiscal and monetary policies turned highly stimulating in 1983. The Reagan Administration expected to contain a renewal of inflation by fine-tuning a slow recovery.

How might these activities be summarized?

1) The specialties of the financial world have been breaking down by the action of firms that have forseen the potentiality of national markets and the possibilities inherent in a revolution in communications. The financial world is entering into a "conglomerate" era, years after the popularity of conglomerates in other industries. This trend is in contest with laws and regulations, which have for years kept the

financial industry in closely regulated specialities and in well defined geographical areas.

2) There appears to be a well-nigh irreversible trend toward financial institutions' operating across state lines.

3) There is an urgent need to overhaul federal and state laws and regulations, which apply to financial institutions. Many of them have become seriously outmoded. Protective supervision of financial institutions is divided between federal and state agencies, and divided again among federal agencies.

4) There has been a tremendous extension of the Federal Reserve system's supervisory responsibilities with respect to reserve requirements to S & L's, credit unions and to previous non-member banks. This extension of powers does not seem to have been carefully thought out either with respect to exercising uniform monetary policy over these diverse institutions or with respect to currently supervising them so that they conduct business with safety.

5) The distinction between financial institutions is becoming blurred: it has been necessary to redefine a bank as a "depository institutions." In an era of managed, fiat money it is absolutely necessary to remember that the banking system, which can create deposit money, is of extraordinary interest to the public, not only because the bank management determines who obtains credit, but because the expansion of bank credit can make for speculative, inflationary booms (and

the excessive contraction of credit can make for recessions). By whatever name, financial institutions, which can collectively create deposit money, require special supervision, as inseparably tied to the public weal.

6) A dual banking system, with banks chartered either by the separate states or by a federal authority, is an anachronism in an age when communications ignore state lines. Competition between federal and state chartering authorities for providing easier entry conditions and easier supervisory conditions has become dangerous to the public welfare.

7) The Federal Government through its agencies provides deposit guarantees up to $100,000 per account on a flat premium assessment basis. In practice, almost all creditors are kept whole, which provides no market discipline to banks which engage in risky lending practices.

The management and the shareholders of financial institutions with guaranteed deposit accounts are enabled to operate with the minimum amount of required capital, while profitably trading on the implicit capital provided by the federal government guarantees. Bank insolvencies were trending upwards in the early 1980s.

AARP's fundamental position is that financial institution innovations are needed to accommodate the many changes taking place in our society. There are continuing general welfare concerns over the regulation of important aspects of the activities of financial institutions. These general welfare aspects are categorized as follows:

A) Financial institutions, which are collectively able to create deposit money, must be circumscribed in their activites;

B) Savings, both large and small, need to encouraged. The movement to larger and larger financial institutions may not be conducive to promoting small savings:

C) The guarantee of "small" savings deposits is conducted in a way which enables affected financial institutions to trade on the implicit capital provided by the government;

D) Bigness is not necessarily badness, but the movement to bigness in financial institutions raises serious questions as to whether or not any anti-trust activity of importance will be taking place in the financial sector;

E) Banking, both in the private sector and central banking, is from time to time much involved in inflationary activity. Although the recent recession much dampened inflation, restraints on inflation should not be imposed on a stop-and-go basis. Some basic reforms are needed.

We turn to these points in the following recommendations.

Recommendations

Commercial Banking

Banking has been undergoing redefinition by the federal government as an activity conducted by any financial institution providing deposit facilities, which can be "checked" upon. Behind this definition has been an intention to impose non-interest earning reserves on financial institutions engaged in "bank-like" activities, so that various types of financial institutions are more or less competitively equal with respect to having a portion of their capital tied up in non-interest earning reserves with the Federal Reserve System. We think it wrong to impose fractional reserves as an equalizing tax. This subverts the primary purpose of fractional reserves, which is to control the creation of deposit money. (This is popularly known as checkbook money.)

All earlier banks were commercial banks, that issued banknotes against fractional reserve of gold and silver. Although the reserves against the money supply created by the private sector banking system are now represented by obligations of the U.S. Government, there is a virtual concensus among monetary authorities that the control of the amount of commercial bank reserves is vital to controlling the expansion of the money supply. These private sector bank reserves are a fractional part of the checkbook money created. The handles we have on controlling the inflation of the money supply are exercised through the central bank (the Federal Reserve System), which determines the amounts of the reserves. Federal laws should not confuse the importance of controlling the quantity of fractional reserves by imposing similar reserves as a species of competitive equalizing tax on selected finaincial institutions.

Commercial banking, whether pursued under the name of commercial banking, or redefined as a depository financial institution creating deposit money in the course of extending commercial loans, is the basic form of banking. It is our view that the fractional reserves of commercial banks must be controlled as a part of monetary policy, which has a continuing objective of keeping inflation rates under control. In addition, riskier forms of financial institution business activities, such as underwriting securities, developing real estate, underwriting property, casualty, and life insurance should be insulated from the ordinary activities of commercial banking operations.

Insulating the commercial banks from the riskier lines of business through acquiring a subsidiary for these activities is imperfect, since the parent company can lose its equity in the subsidiary. A better solution is to use a holding company device with independent capitalization and funding for the commercial banking operation and for the company undertaking the riskier lines of business. Safeguards would be also needed so that any intercompany dealings are conducted on an "arms length" basis. Banking and commerce should not be mixed.

In summary, commercial banking -- no matter how identified -- must be closely circumscribed, for the clear reason that commercial banks create the bulk of our money supply, when extending commercial loans. If other financial institutions differentially identified are given the right and powers to create deposit money, such financial institutions become commercial banks with respect to the laws and regulations which govern the operations of commercial banks. A rose by another name is a rose, is a rose, is a rose.... Commercial operations and finacial institution operations involving substantial risks must be isolated from commercial banking operations.

Savings Type of Financial Institutions

AARP encourages the activity of financial institutions in extending saving facilities to convenient locations, which not only serve the elderly, but small savers everywhere. The United States has a poor recent record for savings, because it has failed to encourage mass savings, because it has held the mistaken belief that new investment capital will only come from the well-to-do. The move to larger conglomerate financial institutions, raises some concern that small savings accounts may be neglected in favor of more profitable lines of activity. Small savings accounts are guaranteed by the federal government, so that the depositor is secured even though the financial institutions, offering the facilities, might engage in lending activities or in business activities of an innovative nature, as opposed to traditional operations. We do not see any objections to innovative activities, providing appropriate capital requirements are met, or appropriate reserves are set aside by mutual institutions. If the innovative activities raise the operating risks significantly, the premiums for government deposit insurance should be appropriately raised. Appropriate disclosure should be made.

Interest rates on various types of savings accounts should be market determined, rather than determined by state and federal regulations.

Deposit Insurance

Section 712 of the Garn-St. Germain Depository Institutions Act of 1982 (Public Law 97-320) mandated studies of the way federal deposit insurance is being conducted, requesting recommendations on reforms. The Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board have recently responded with studies and recommendations. Both of these reports recommended variable deposit insurance premiums, with varying emphasis, so that the inequity of charging the same premiums for deposit insurance, without regard to the character of the operations of the insured institution, would be removed -- at least, in part. We endorse this recommendation, although we think that the Federal Government should move in this direction promptly and be not so timid in setting up variable deposit insurance premiums, which would reflect great differences in the risks of operations.

Although the rescues by the Federal Government of the Lockheed Corp. and the Chrysler Corp. have provoked much debate over the wisdom of what has been popularly called "lemon socialism," it is not generally realized that the Federal Government stands committed to rescue almost any bank or "thrift" from insolvency, with little regard to the causes of the insolvency. The procedures for the rescue operation -- in a most simplified summary -- are for the depository insurance agency to make the balance sheet of the insolvent corporation "whole," so that it is satisfactory to another solvent bank or thrift, which has the capability of managing the insolvent institution. The two institutions are then merged.

The argument advanced for this type of rescue, known as purchase and assumption operation to the insurance corporations, is that the costs of this type of rescue are less than paying off all depositors with account of $100,000 or less. Another argument is that the insolvent corporation continues in business without interruption and without inflicting other losses on it creditors. If the costs of this type of rescue operation are, indeed, less that a straight insurance payoff approach, one strains to make arguments against the procedure. However, it cannot be denied that when the government keeps all creditors whole, and not just the depositors, the goverment is implicitly supplying capital to the financial institution it guarantees.

The effective capital of the guaranteed financial institution is, in fact, very much larger than shown on the balance sheet. Creditors know this and the bank management knows this. Bank management, who so desire, can trade on this implicit capital, to the profit of the shareholders (or to the profit depositors in mutual institutions). The owners of the banks loan capital are likely to impose no market discipline on the bank, since they have almost no risk of losing their capital. If a lender's capital winds up as a bank loan to an LDC (less-developed country) with a doubtful ability to roll-over the loan, the lender is not really concerned.

AARP supports early steps to make the management, shareholders, and suppliers of loan capital of financial institutions with guaranteed deposits more responsive to market forces. To stop the trading on implicit capital the paid-in capital of financial institution should reflect the risks of doing business. The depositors with balances in excess of $100,000 might be required to co-insure, thereby giving them an interest in the conduct of the institutions operations. Lenders of other forms of loan capital should not expect to come out completely whole, thereby giving them an interest in imposing market disciplines on the shareholders and management. Variable rate premium insurance should be imposed on guaranteed institutions so that the earnings of depositors in conservatively run banks are not reduced by having to absorb the higher premiums which "go-go" banking operations should entail. (There isn't much point in driving your car with great care, if your car insurance premium is the same as your neighbor, who bashes a fender every six months.)

STATEMENT

OF THE

AMERICAN ASSOCIATION OF RETIRED PERSONS

ON

THE CURRENT STATUS AND THE FUTURE DIRECTION OF THE FINANCIAL SERVICES INDUSTRY

The American Association of Retired Persons is pleased to be invited to present its views on the financial services industry. Our 14 million members have a direct interest in the efficient functioning of the industry and its serving the interests of consumers, savers, and investors. The elderly are also interested in preventing the recurrence of the high inflation rates which marred the economic landscape in the 70's and early 80's and have some suggestions to advance that end.

The focus of these comments will be primarily on the banking and other deposit-type industry, because that is where the interests of most of our members are. For the most part, we take no position with respect to the several turf battles now being waged within the financial services industry.

Elderly Consumer Interests

The elderly consumer's interest in deposit-type institutions can be divided into three main categories: safety, convenience, and full disclosure. The safety of deposits is best ensured by an effective insurance system for smaller depositors. Convenience means ease in dealing with depository institutions, both in receiving and making payments. Disclosure refers to the terms not only on loan activity, but also to what is more important to the elderly--savings and checking accounts.

Deposit insurance has been without doubt one of the success stories of the post-depression period, and it needs to be preserved and strengthened. The recent study by the FDIC made some useful recommendations for strengthening, notably by developing a schedule of premium rates, that are more closely related to the risk involved in insuring particular institutions. The recommended merger of the two insurance corporations is also worth considering.

The deposit institutions have been innovative in developing new types of payment facilities, in particular automatic teller machines (ATM's) and direct deposit of payroll and social security-type checks. The ATM's have been a particularly useful contribution to convenience, despite some objections to the impersonal nature of the transaction. Electronic Funds Transfer (EFT) also has the potential of improving the productivity of the payment system by reducing the volume of paper that threatens to overwhelm the check clearing machinery. Our sole reservation on the direct deposit aspect of EFTS is that the burden of ascertaining whether the direct deposit, say of a social security or federal government retirement check, has actually been made, has been placed entirely on the recipient of the check. Many of our members are uneasy about this feature of direct deposits.

The flood of new payment and saving instruments has made adequate disclosure of terms on all payment and savings instruments more important than ever. There must be many individuals, many of them also elderly, who have difficulty comprehending the sometimes minute differences between different types of accounts. This is particularly true of the cafeteria menu of savings instruments now available. We hope that when the FDIC has completed the long-overdue dismantling of Regulation Q, that the financial institutions will find it desirable to reduce the variety of certificates available.

Elderly Interest in Preventing or Reducing Inflation

The Association identified inflation as Economic Public Enemy Number One several years ago, and at the same time identified restraint in expanding the money supply as one of the key ingredients of an effective anti-inflationary policy. As a measure of achieving restraint in money creation, an anti-inflation monetary policy has also come to mean preserving the capability of the Federal Reserve system to pursue the appropriate monetary policy free of interference from the Administration of the day and from Congress, both of which are usually pushing what are frequently characterized as "cheap money" policies.

Looking ahead, but perhaps not too far ahead, we see the need for starting now on legislation which would create the framework for dealing with the cost-push pressures of inflation when the need arises. This means some kind of incomes policy to obviate the necessity of imposing severe disinflationary policies in the event of a resumption of high levels of inflation. We have heard all the arguments about the undesirability of "wage-price controls". We have heard that rigid controls cannot be made to work in a peacetime setting and that any kind of restraints on earnings and price inflation are difficult to formulate and maintain. We would like to ask persons who make those arguments, however, whether they prefer the anti-inflationary poliicy of the past five years, with its large-scale unemployment and dislocation of major industries, because that is the realistic alternative to an incomes policy. Is severe disinflation the best way of combatting inflation? It seems to us, it is not.

Elderly Interest in More Competitive and Efficient Structure of Deposit Industry

The primary importance of an effective deposit insurance system cannot be overstressed, and some ways to strengthen that system were suggested earlier. Strengthening the insurance system includes rationalizing the supervisory function at the federal level, and possibly, removing the Federal Reserve System entirely from supervision, as well as from other forms of regulation. The aim would be to enable it to concentrate on its primary responsibility -- monetary policy and control over money supply growth.

Our assumption is that Congress will authorize the removal of regulatory barriers, both between presently separated industries and geographical areas. Given that assumption, two cautions should be observed:

(1) The existence of an adequate payment system, at one time restricted to the banking industry, needs to be guaranteed, probably as a "common carrier" responsibility of whatever kind of deposit industry emerges.

(2) The antitrust laws should be vigorously enforced against all financial institutions, including such nonbanking industries as insurance. The present unconcentrated character of the deposit industry makes this unnecessary, but this condition will change.

The **Chairman**. Thank you, Mr. Hacking.

Mr. Nishimura, you believe, as you state in your testimony, that adequate disclosure of terms and conditions of savings instruments are essential. I certainly agree. Our only disagreement in the past, as you have been here to testify before, is how we achieve that, the complexity of the regulations, when you have a disagreement over such things as truth in lending—not in the goal or what we are both trying to accomplish, but the complexity, and does it truly accomplish that goal.

Let me ask you, What do you specifically contemplate should be included in such a disclosure as you advocate in the truth in savings?

Mr. **Nishimura**. Well, Senator, I agree with you that it is a difficult subject. There are separate proposals. There is a Model Truth In Savings Act. There is a member of ours at Kansas State University, Dr. Morse, who has devised his own system of truth-in-savings disclosure.

I think in a broader sense of addressing the question, there has been, also, a proposal that local consumer groups ought to be allowed to evaluate the various local savings options to the benefit of their community, because all of the various savings options might not be available in each community, and only those ones that are available should be subject to comparison.

So while there are a wide variety of proposals on truth in savings, I am really not prepared at this time to go over how, in fact, that can be carried out.

ADVOCATING LEGISLATIVE DISCLOSURE REQUIREMENTS

The **Chairman**. But you are advocating legislative disclosure requirements?

Mr. **Nishimura**. Well, let me just jump back a little bit to the statement by Mr. Hefner on the EFT and how EFT progress would be impeded if the standard that the consumer needed a printed receipt were to be upheld. I think in that case it was appropriate for the Federal regulators to say, "Yes; you ought to go ahead with this experiment," but I do not think the Federal regulators ought to lose sight of what the intent of that consumer protection was. The intent was, how is the consumer going to be protected against a situation where the consumer and the banker disagree? In just the same manner, I believe that Congress should state the intent that that ought to be resolved by regulatorys, whether deregulation occurs or in whatever situations that develop; that the consumer ought to be protected from certain types of practices, and a responsive regulatory mechanism ought to be in place.

The **Chairman**. What I am specifically getting at is even broader than what you are discussing, whether we get into rigid legislative disclosure requirements. I think this would lead us to the truth in lending type morass with its incredible complexity, legal difficulties, and the information overload that we have experienced. That's a battle that we still can't seem to come to an agreement on. Even though we agree on what truth in lending is supposed to accomplish, we agree that that's a worthwhile goal, to protect consumers and give them adequate information—I am still just appalled at the information overload and the complexities of the forms and the inability of the average consumer to understand what is being disclosed to him through truth in lending.

When you talk about truth in savings, I don't necessarily have any objection to the concept, but I don't want to get into another rigid, inflexible type of situation that doesn't serve the consumer and causes a great overload on the institution.

Mr. NISHIMURA. Mr. Chairman, the problem that has developed over that concept of truth in savings, I think, is that the tendency for the market to develop instruments outside of the purview of any legislation—and I think we ought to recognize that that will occur.

On the other hand, we have to go back to our basic point, in responding to consumer concerns. A market cannot be truly competitive if consumers are at a loss for information on how to compare their options. A market cannot be competitive. It's a basic principle. And without some kind of truth in lending that is standardized, without some kind of mechanism like that to make all the instruments and elements out there comparable, then no other change ought to be made in the name of the competitive market, because consumers are just unable to operate in it.

I understand your point, and we have discussed this in the past. I think the government ought to explore different approaches.

I fear that if I follow your reasoning too much, or agree with you too much, the only answer that we can get is that the government shouldn't do anything about it; the market will take care of it. I think that is not an adequate response.

The CHAIRMAN. I don't think that is what I am indicating at all. I thought you were going to say if you agreed with me too much you might get fired. [Laughter.]

Mr. NISHIMURA. Well, Senator, I just want to be clear that we at CFA can also accommodate your membership, if you so desire, in our organization. [Laughter.]

The CHAIRMAN. I qualify by age.

No; once again—I am going to try once more. I don't disagree with what you have just said about the need for consumers to be able to compare. I still have to make the point at every opportunity that I get that truth in lending does not give that person the opportunity to compare, because of its complexity. Never have I indicated that Federal truth in lending should be repealed, or that there is not a Federal role in that area. I don't want your last statement to indicate that I or anybody else that I know of feels that way.

But to someday come to grips and have some aid from your association in coming up with truth in lending modifications that accomplish the goal of both you and I, personally, and the association and Congress agree, so that an unsophisticated borrower can have placed before him a disclosure that is understandable, that is simple enough to be comprehended, and simple enough to be compared with that disclosure from another institution, so that he does have comparison shopping.

COMPLEXITY HAS DEVELOPED AROUND TRUTH-IN-LENDING

After all these years of truth in lending, I do not believe that goal has been accomplished, or even close to it, because of the legislative morass of rigid rules and arguments about how you compute APR.

Once again, when we get to a form about this big that says: You have borrowed *X* number of dollars. You will pay back *X* number of dollars. Your annual percentage rate is this—a maximum of about five disclosures—then we will have something that accomplishes what you and I think we should be accomplishing.

The only reason I bring this up again, if we get to the point when we are considering truth in savings—if we don't have the kind of law that I am trying to describe that accomplishes the purposes we agree on, there will be no law.

I will do everything I can to see that we do not create another mess like truth in lending, and I wish, as we consider that, we could do something responsible, creatively, together, about making truth in lending, fair credit reporting, equal credit opportunity, and all of those understandable. But it seems impossible to get together and get away from the attorneys that have designed these, and something that those of us who are not attorneys can understand.

That is the only point I am trying to make, and I don't mean every time you come here that you know you are going to get it, but I really want changes to happen, I really do, as sincerely as I can. I want those consumers to be adequately served.

Mr. NISHIMURA. I agree with you, Senator, that the objective is clear and simple disclosure. We at CFA find disclosure to be a very powerful force in the marketplace. But I think that the complexity that has developed around truth in lending is an indication of the complexity that is developing for consumers in the marketplace.

Under the adjustable rate mortgages, and under the way that houses are sold today, for instance, if a seller paid his lender points, and the lender then raises the cost of a home in exchange for an interest rate consideration, the cost of the house to the buyer would increase. And in the purchase of the house, that increase is not considered interest. When in fact, it is interest.

How do you contend with that in an environment where you would like all of the credit costs to be disclosed separately?

I agree with you, Senator, that what is immensely desirable is a clear, short statement that is useful and efficient for consumers. I don't want to give you the impression——

The CHAIRMAN. Are you an attorney?

Mr. NISHIMURA. No; I am not.

The CHAIRMAN. Do you think if we both got rid of our attorneys that you and I could sit down——

Mr. NISHIMURA. Senator, I would be willing to sit down with you any time. But I am not sure where our conversation would end up——

[Laughter.]

The CHAIRMAN. Senator Lautenberg?

Senator LAUTENBERG. Thank you, Mr. Chairman. I think that the positions that Mr. Nishimura just expressed, and even some of the terminology that I used in my own statement before, are, coincidentally, the same. I have a concern about the consumer.

I greatly respect your point of view about complicated reporting systems that do more to befuddle than to simplify, and we have an obligation, I believe, to be certain that the consumer at the financial institution, whether it is a mortgage or ordinary lending or a security deposit, has to be serviced. I have indicated my concerns before, so thank you very much, Mr. Chairman.

The CHAIRMAN. Well, for your benefit, let me just carry on a little bit more. Mr. Nishimura has heard it before, and I couldn't agree more with what you just said, either. I don't know, I will continue to fight, as I have for 8 years, somehow to get it out of the legalese language.

It's better than it was. At one time, there were certain Federal court jurisdictions in this country where 40 percent of their entire caseload was truth-in-lending violations. Supercritical, hypertechnical, dealing with a dotted "i" and crossed "t" that had no real merit. A minimal, $100 recovery; massive numbers of them. Attorneys are not going to fight over a hundred bucks. I'll get 50, you get 50. Go play that game. That's the only place I argue.

Often people say, "You're anticonsumer." Oh, no. I believe just as much in what you and Mr. Nishimura have said is the goal as anybody who represents any consumer. My puzzlement, my absolute frustration, comes from consumer groups that can defend not the goal, but the incredible morass of legalese we have put together, because I once, several years ago, conducted a very, very informal, unscientific survey in Salt Lake City. I had some of the banking institutions empty their wastebaskets and found that more than 70 percent of the truth-in-lending disclosures were thrown in the wastebasket by the people they were given to.

So again, the intent is there. It's good, but those consumers weren't being served. They didn't understand the disclosures enough to want to keep them. They just threw them away.

I found in my own experience, Bob Morgan and I, former Senator from North Carolina, the first year—we were new Senators in 1975—we passed a RESPA simplification act, and we got flack in presentations. But a lot of people patted us on the back and said, "Hey, that's great." In October of 1981, it was the first time since we had simplified RESPA, I took out a new mortgage, personally.

I was the chairman of the Banking Committee at the time. I had been the author of this legislation. I sat down—that guy handed me one piece of paper after another, and I read through them, and I had to sign all of it, and I am not kidding, I didn't know what I was signing. I would have had to go to my attorney, if I would want to go through that. So I just accepted it. I said, "All right. I don't need to even read the rest of them, because I am not going to take the time, and I am certainly not going to hire an attorney to go tell me all that you have just disclosed to me."

That's the point I am trying to make, Senator, and I am supposed to be knowledgeable. Now, I didn't understand all those things. You take some middle or lower income person who comes in with these disclosures, and you hand all this to him. Mr. Nishimura, my staff may understand it all and they can argue back and forth about it. But I don't really believe they are serving the consumers, if we cannot devise some simpler means of disclosure that they will understand and not throw away.

That is the only point that I continue to make, every time this discussion comes up, and why I continue to fight to simplify these acts, even though I get attacked as being anticonsumer—which I am not, and want exactly the same things that Mr. Nishimura's organization does. We always seem to come at loggerheads when any attempt to simplify these laws is described as anticonsumer, and there just seems to be a Chinese wall there.

I cannot believe that the legal profession is not intelligent enough to simplify those acts. In insurance policies, it has been done. I used to sell insurance policies. I did for a long number of years. Most of the years I sold them, I didn't understand the terms of the policy. But there is plain language. They're much simpler than they used to be, much more understandable. You can actually read the terms of the insurance policies, now. And that is what I am trying to get at, and will continue to. As long as I am here, it will be a crusade to have something.

First of all, I guess, the first test is can I understand it without going back to law school at a retired age of 50? [Laughter.]

Senator LAUTENBERG. Mr. Chairman, I don't want any misinterpretation of my silence. I have so many lawyer friends. I believe——

The CHAIRMAN. You're about to lose them. [Laughter.]

Senator LAUTENBERG. I believe that the services rendered by that profession are valuable.

However, since you have greeted me so warmly as a fellow businessman and not as a lawyer, it makes me curious as to why you weren't out campaigning for me in New Jersey when I needed help. [Laughter.]

The CHAIRMAN. I didn't want to hurt you. [Laughter.]

When anybody asks me for an endorsement, I always tell them that, well, you decide whether I will help or hurt, and I will be happy to do whatever you would like me to do.

Senator LAUTENBERG. See, Senator Garn, a frontiersman in the real sense of the word just said here publicly that he didn't want to hurt me in my quest for a Democratic seat in New Jersey.

The CHAIRMAN. My father was a Democrat, but I repented. [Laughter.]

Gentlemen, we appreciate your willingness to testify today. Thank you very much.

[Whereupon, at 11:25 a.m., the hearing was adjourned.]

FINANCIAL SERVICES INDUSTRY—OVERSIGHT
Part II

THURSDAY, JUNE 16, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room SD–538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Gorton, Hecht, and Lautenberg.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order. We continue the hearings on conditions in the financial institutions industry.

I might say at the outset that I appreciate Senator Hecht—I appreciate him every day, but particularly today. I have not missed any of these hearings but we are in the silly days of June in the Senate where we have all kinds of competing meetings and markups, and as a member of the Appropriations Committee—we have a markup in the full committee at 10 o'clock, which I must attend. So about 5 to 10 o'clock, if the witnesses will excuse me, I unfortunately will have to leave and go to the Appropriations Committee meeting, but will turn the chair over to the able Senator from Nevada, Senator Hecht.

Today marks the 50th anniversary of the enactment of the Glass-Steagall Act, which was born in the upheaval of the Great Depression. The act has served as one of the cornerstones of our financial system for the past five decades. By removing banks from securities activities which had contributed to economic troubles of the 1930's, the act helped to insure the stability of the system. The act's message was simple enough: Banks were to be banks, and securities firms were to be securities firms.

What Senator Glass and Congressman Steagall accomplished was a reinforcement of historical distinctions. As indicated in the 1931 Senate Banking Committee hearing on legislation which preceded the act, prior to the 1920's:

> The banking system of this country was largely divorced from the market for securities, and disastrous experiences of bank failures due to frozen or worthless security holdings . . . tended to enforce that separation of commercial from investment banking in law. (The Banking Committee's hearings on the operations of the National Federal Reserve Banking Systems, part 7, page 979, in 1931).

In the same committee hearing record, the problem of having banks involved in low margin security loans—in June 1930, 19 percent of bank assets were in such loans—investing in various types of debt and equity securities, and engaging in a broad range of securities underwriting and dealing activities through securities affiliates these were described and discussed in much detail.

The dangers of having banks own securities affiliates with unlimited powers was noted by the Comptroller of the Currency in 1920. In the Report of the Comptroller of the Currency for 1920, page 1067, the Comptroller made the following statement:

> Some securities companies operate in close connection with and are often officered by the same men who manage the national banks with which they are allied and have become instruments of speculation and headquarters for promotion of all kinds of financial schemes.

The Comptroller went on to indicate that some of the problems of securities affiliates had poured over into their banks, damaging the banks' credit and reputation.

The system established in the 1930's has obviously worked because of the Glass-Steagall Act as well as the Federal Deposit Insurance Act, the securities laws, and the Home Owners Loan Act. We have had a highly regulated, diversified, and, most important, stable financial system which has served the needs of individual and business consumers.

Looking at events within the financial system during the past few years, it is obvious that market conditions, driven by technological and other advancements, have changed considerably since the 1920's and 1930's. We are a much more mobile and sophisticated society. The innovations and tensions caused by NOW accounts, EFT systems, money market funds, nonbank banks, and similar changes signify we have traveled a long way since congressional consideration of the Glass-Steagall Act.

Such changes produced a realization that adjustments to the Glass-Steagall Act and other Depression era legislation must be considered. That is what these hearings are about today and what they have been about in the past few weeks and will continue into the next few weeks.

Such changes do not necessarily violate the underlying principle of those acts. In fact, with all the loopholes and creative lawyering of our time, such changes may tend to preserve and reinforce many of those laws. In any event, the Glass-Steagall Act must not be treated as a static monument; it rather must be reviewed in the face of current events.

Thus, in opening this hearing, we cannot help but admire and laud the efforts of Senator Glass and Congressman Steagall in making sense out of the chaotic environment and wish their legislative hallmark a happy birthday. It is up to us to insure that the perspective which their legislation has provided the financial system over the past 50 years is made relevant to the needs and demands of the financial system of our and succeeding generations.

Gentlemen, we are happy to have you with us this morning. Our first witnesses are the Honorable Charles Bowsher, Comptroller General of the General Accounting Office, and K. Houston Matney, Securities Commissioner of the State of Maryland, Chairman of the

Financial Institutions Committee, North American Securities Administrators Association.

Mr. Bowsher, would you please proceed.

STATEMENT OF CHARLES A. BOWSHER, COMPTROLLER GENERAL, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY ART GOLDBECK, ASSOCIATE DIRECTOR, AND RANDY SCHULTZ, SENIOR EVALUATOR

Mr. **Bowsher**. Thank you very much, Mr. Chairman, members of the committee. I am accompanied today by Art Goldbeck and Randy Schultz of the GAO, and we are pleased to be here today to discuss one of the most important questions in the financial services industry today, namely, that the industry is changing, and what should be the government's role with respect to these changes.

IMPACT OF INDUSTRY CHANGES

In my testimony today, I will discuss the impact of industry changes on the protections provided to depositors and investors, and I will address the question of the continuing relevance of the current financial services regulatory structure.

The changes we see occurring today are the latest events in the historic development of the financial services industry. Before the financial collapse in 1929, many discrete depository insurance organizations contested for customers' funds. In contrast to today, these organizations and markets were relatively free from regulation, and depositors and investors had relatively few protections for their savings and investments.

After the collapse, as you pointed out, Mr. Chairman, the Congress created in the 1930's regulations and protections to restore public confidence in the financial system.

Now, it should be noted that the Congress designed the legislation in the 1930's for a financial system which was comprised of separate and distinct deposit and investment industries. The Congress stated its desire to keep banking separate from other lines of businesses, and this separation generally continued through the early 1970's.

Beginning in the late 1970's and continuing today, traditional financial institutions and nonbank commercial firms have gone after each other's lines of business, blurring the distinctions among formerly separate industries, and these changes have continued to accelerate. Although depositors and investors can benefit from the introduction of new financial products, I am concerned that the merging markets are creating gaps and overlaps in the available protection.

For example, checking accounts are now available from banks, thrifts, securities brokers, credit unions, and investment companies. A customer placing money in one of these accounts may or may not be covered by deposit insurance. The institutions offering the accounts may or may not be subject to regular, detailed scrutiny by Federal examiners, and those examinations might differ vastly in form and coverage.

It is noteworthy that these industry changes are taking place in spite of existing laws and regulations. For example, through a series of legislative amendments, the definition of a "bank" in the Bank Holding Company Act was narrowed to include only those institutions which both accept demand deposits and make commercial loans. So when Gulf & Western acquired Fidelity National Bank of Concord, Calif., and divested the bank of its commercial loans, Gulf & Western was not held to be a bank holding company even though Fidelity could still hold federally insured deposits and make personal loans.

Furthermore, not all the restrictions on federally chartered banks apply to institutions with State charters. The Glass-Steagall Act prohibits national banks and other Federal Reserve member banks from underwriting securities, but the Federal Deposit Insurance Corporation has determined that the act does not preclude an insured bank that is not a member of the Federal Reserve System from acquiring or establishing a subsidiary to underwrite securities, provided certain safeguards exist.

As this committee has heard, several States, such as South Dakota and Delaware, either have made or are considering changes in their own laws that would allow their State-chartered banks to conduct activities now prohibited for national or Federal Reserve member banks. I believe that Congress should consider assuring that all federally insured institutions are regulated consistently to maintain the safety of our Nation's banking system and protect the depositors.

In light of these events, I think it is important that the Congress ascertain the direction in which the financial services industry is headed, assess the need for changing the restrictions now imposed on the market, determine the protections to be offered depositors and investors, and carefully evaluate alternatives for improving Federal financial services regulation.

Banks are still seen as something special, special institutions, because they play a critical role in the Nation's economy as suppliers of credit and a link to the monetary policy. Few have challenged the long-held, public policy concern for maintaining confidence in the safety and soundness of our financial system in general and in depository institutions in particular.

DIVERSIFYING LEADS TO GREATER RISKS

GAO has reported several times that traditional depository institutions have actually increased their risks by diversifying into lines outside their normal ones. In 1978, we reported that savings and loan associations owned by holding companies experienced problems caused by the companies' nonbanking subsidiaries. In both 1981 and 1982, we reported data which suggested that bank holding companies with nonbank subsidiaries are more likely to have problems than holding companies without nonbank subsidiaries. Risks created by a firm's opening new lines of business can be successfully managed; however, since banks are thought of as special, and since public confidence in the financial system is important, the Congress should carefully reassess the need for restrictions on banks' lines of business before making legislative changes.

Earlier I expressed concern that the merging product markets are creating gaps or overlaps in protections for depositors and investors. I believe that the variety of competing products now being offered can confuse consumers, especially small depositors who have a variety of investment motives.

Beyond this, I believe that sometimes subtle differences in the protections covering those products can be confusing. Let me illustrate what the variances might mean to small depositors or investors. I noted earlier that banks, savings and loans, and money market mutual funds offer similar deposit-like products in which customers may place even modest amounts of money. If, for example, a bank or an S&L became insolvent, deposit insurance would generally cover each account up to the $100,000 maximum; however, if a money market fund suffered a drastic drop in the value of its investment portfolio, the value of the investors' shares would also drop, but no comparable insurance would cover the investors.

Deposit insurance also helps prevent bank failures by discouraging runs on banks that have financial problems. If investors lose confidence in a money market mutual fund, no similar insurance would decrease the likelihood of a run on it, nor, in the worst-case scenario, runs on several funds with comparable investment portfolios. It is clear that many consumers have exhibited preferences for both higher rates of return and a higher degree of protection. That is why I think that the variances in investment protection, coupled with the variety of risk/reward alternatives offered in today's market, can confuse the average financial services customer.

Once the Congress has a better idea where the market is headed, and after the need for various restrictions has been reevaluted, alternative regulatory approaches can be studied.

The restructuring of the Federal financial industry regulators has been debated for many years. In the past, the call for restructuring was based on the perceived inefficiencies and lack of coordination among the depository institutions' regulatory agencies. Now, though, the debate also focuses on the market changes that may render inappropriate the current structure for regulating all financial industry activities.

We at the GAO are now conducting or will be starting a number of studies to help the Congress evaluate regulatory structure alternatives.

The basic protections—insurance of investor funds, on-site examinations, and disclosure of information—can be altered and combined in a variety of ways to suit particular products and institutions. Consequently, we will study many of these issues: One, the changes in and directions of the market; two, the effect these have had on current regulatory structure; three, the role in the structure of the various regulatory methods, including the best methods to assure adequate protection for depositors and investors; four the nature of the risk involved with various product lines; and finally, the strengths and weaknesses of alternative regulatory structures.

Although we intend to report periodically on the results of these studies over the next few years, we expect, as I mentioned earlier, to be able to help and to offer some valuable information to the Congress in the interim.

Mr. Chairman, this concludes my summary of my formal statement. I would hope that the formal statement could be included in the record. We would be happy to respond to any questions at this time.

[The complete statement follows:]

United States General Accounting Office
Washington, D.C. 20548

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STATEMENT OF

CHARLES A. BOWSHER

COMPTROLLER GENERAL OF THE UNITED STATES

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS

ON

CHANGES IN THE FINANCIAL SERVICES INDUSTRY AND THEIR IMPACT ON FEDERAL REGULATION

Mr. Chairman:

I am especially pleased to be here to discuss one of the most important questions in the financial services industry today: How is that industry changing and what should be the Government's role with respect to those changes? I think we all realize that the changes are both rapid and complex. It is appropriate, therefore, that we move with deliberate speed to address the problems caused by these changes. I say deliberate speed because our work to date indicates that some important questions need to be answered before the Congress enacts major legislation.

In my testimony today I will discuss the impact of industry changes on the protections provided to depositors and investors, and I will address the question of the continued relevance of the current financial services regulatory structure. I will highlight the conclusions we have reached from our studies to date and outline the future work that we will undertake to help the Congress address these complex issues. We have been studying some relevant issues over the past couple of years and will be looking at others in the next few years, reporting on them periodically. We will, of course, stand ready in the interim to provide assistance to the Congress.

The changes we see occurring today are the latest events in the historical development of the financial services industry. Before the financial collapse in 1929, many discrete depository, insurance, and investment organizations vied for customers' funds. In contrast to today, these organizations and markets were relatively free from regulation, and depositors and investors had relatively few protections for their savings and investments. After the collapse, the Congress created in 1933 and 1934 regulations and protections to restore public confidence in the financial system and promote the orderly intermediation of savings to investment.

I want to note here that the Congress designed the legislation of the 1930s for a financial system which, in one important respect, differs from the system we have now. The basic deposit insurance, public disclosure, and regulatory requirements designed 50 years ago assumed separate and distinct deposit and investment industries. The Congress stated its desire to keep banking separate from other lines-of-business by prohibiting federally chartered banks and Federal Reserve member banks from engaging in activities such as securities underwriting. This separation generally continued through the early 1970s.

Beginning in the late 1970s and continuing today, traditional financial institutions and nonbank commercial firms have made incursions into each others' lines-of-business, blurring the distinctions among formerly separate industries. These changes have continued to accelerate.

An early break in the traditional boundaries separating components of the financial services industry was the Merrill Lynch Cash Management Account, first offered in September 1977. This account provided customers with brokerage services, higher interest than regular depository institution savings accounts, checkwriting privileges, and use of a debit card.

More recently, some companies involved in unrelated activities have merged to expand their positions in the financial services industry. Prudential Insurance Co. acquired the Bache Group Inc., a securities firm, and has announced intentions to acquire a commercial bank; American Express Co. acquired Shearson Loeb Rhoades, a securities firm; Sears, Roebuck & Co. acquired Coldwell Banker, a real estate company, and Dean Witter Reynolds, a securities firm (adding to its existing savings and loan association and insurance company); and BankAmerica Corporation acquired The Charles Schwab Corporation, a discount broker. The savings and loan (S&L) industry created INVEST, a program through which participating institutions offer discount brokerage services. About 600 depository institutions now offer discount brokerage services to their customers or are working out the details to do so. Most of these services are offered through affiliated discount brokers.

Although depositors and investors can benefit from the introduction of new financial products, I am concerned that the merging markets are creating gaps and overlaps in the available protections. For example, transaction accounts, such as checking accounts, are now available from banks, thrifts, securities brokers, credit unions, and investment companies. A customer placing money in one of these accounts may or may not be covered by deposit insurance. The institutions offering the accounts may or may not be subject to regular, detailed scrutiny by Federal examiners, and those examinations might differ vastly in form and coverage. These differences become even more significant as the products become more complex, and it is likely that consumers can become confused about what their protections and risks really are.

It is noteworthy that these industry changes are taking place in spite of existing laws and regulations. Various methods are being employed to avoid prohibitions. For example, the Bank Holding Company Act and the Federal Reserve's regulations were intended to confine the business of organizations owning banks to certain activities closely related to banking. But, through a series of legislative amendments, the definition of a bank for the purposes of that act was narrowed to include only those institutions which both accept demand deposits and make commercial loans. So, when Gulf and Western acquired Fidelity National Bank of Concord, California, and divested the bank of its commercial loans, Gulf and Western was not held to be a bank holding company even though Fidelity could still hold federally insured deposits and make personal loans. In this way, the restrictions of the Bank Holding Company Act were avoided.

Furthermore, not all the restrictions on federally chartered banks apply to institutions with State charters. The Glass-Steagall Act prohibits national banks and other Federal Reserve member banks from underwriting securities. But the Federal Deposit Insurance Corporation (FDIC) has determined that the act does not preclude an insured bank that is not a member of the Federal Reserve System from acquiring or establishing a subsidiary to underwrite securities, provided certain safeguards exist (such as dealing only through a bona fide subsidiary in certain types of securities with a ceiling on the amount of a bank's investment).

As this committee has heard, several States such as South Dakota and Delaware either have made or are considering changes to their own laws that would allow their State-chartered banks to conduct activities now prohibited for national or Federal Reserve member banks. This affects the banks' relative competitiveness and their risk levels. Consequently, I believe the Congress should consider assuring that all federally-insured institutions are regulated consistently to maintain the safety of our nation's banking system and to protect depositors.

In light of these events, I think it is important that the Congress ascertain the direction in which the financial services industry is headed, assess the need for changing the restrictions now imposed on the market, determine the protections to be offered depositors and investors, and carefully evaluate alternatives for improving Federal financial services regulation.

MARKET DIRECTION SHOULD BE UNDERSTOOD

Before legislation can be designed to adequately deal with market changes, the first step is to identify what is happening in the financial services industry, why it is happening, and where things are headed. It may seem as though a lot has already been written and said on this subject. Changes have been so varied and rapid that a precise description is impossible. But I feel that a comprehensive, objective, and organized analysis of what is occurring and where the markets are headed would be of value to the Congress. We are now undertaking a study which will address

--what new products are being created and who is offering them,

- --what the impact of these products is on the current regulatory structure, and
- --what protections apply to the new offerings.

Early next year we should be able to provide the results of this study. Based on past work, though, we know that merely obtaining data on the various activities conducted by both depository and commercial firms will be difficult. Assessing the impact of the activities on just the firms themselves, let alone on investor protection and the regulatory structure, will be even more difficult.

The reason for the difficulty, as we stated in a report last year on depository institutions' ancillary activities, is that the various Federal regulators' reporting systems do not have enough centrally available data on what activities are being conducted and how these activities affect financial and commercial institutions. We noted two kinds of shortcomings in the data. First, not enough information is gathered by regulators. Second, not all of what is gathered can be effectively aggregated for industrywide studies. Therefore, it would be difficult for either the regulators or the Congress to base substantive policy decisions on data which the Federal agencies routinely gather and aggregate.

Federal depository institution regulators routinely collect data on the financial conditions of their constituent institutions and their holding companies; but their systems do not collect data on the full extent and nature of either banks' or holding companies' nonbanking subsidiaries. In fact, we found that even the data they collected on the number of subsidiaries owned by banks are sometimes unreliable.

Moreover, we noted that commercial firms conducting banklike activities generally do not report their activities in a form that can be readily compiled and analyzed. Commercial firms submit information required by various regulations, such as the Securities Exchange Act of 1934 which pertains to publicly held companies. However, while general statistics on major industries are compiled, the available data do not show the nature and extent of banklike activities conducted by commercial firms. Financial information on these activities is not separately identified. Instead, results of these operations are consolidated with data on other operations in the firms' overall financial statements.

Notwithstanding these data deficiencies, it is imperative that we comprehend as clearly and completely as possible the implications of industry change for investor protection, competitive relationships within the industry, and a regulatory structure which was established half a century ago. The study we have just begun, and others we will do, will help assess these implications.

REASONS FOR RESTRICTIONS NEED TO BE REASSESSED

While much has changed in the industry since the 1930s, the original policy reasons for creating regulatory restrictions must not be overlooked even as market pressures build for legislative action.

Expanding lines-of-business create additional risks

Banks are still seen as special institutions for many reasons. As the Chairman of the Board of Governors of the Federal Reserve System has pointed out to this committee, banks play a critical role in the Nation's economy as suppliers of credit and as a link to monetary policy. Few have challenged the long-held public policy concern for maintaining confidence in the safety and soundness of the financial system in general and in depository institutions in particular. That is why deposit insurance was created; and as long as the Government insures deposits, some measure of regulation is appropriate.

GAO has reported several times in the past few years on how traditional depository institutions have actually increased their risks by diversifying into lines outside their normal ones. In 1978, we reported that savings and loan associations owned by holding companies experienced problems caused by the companies' nonbanking subsidiaries. In 1981 we reported data which suggested that bank holding companies with nonbank subsidiaries are more likely to have problems than holding companies without nonbank subsidiaries.

In our 1978 report on S&L holding companies, we noted that nonbank service corporations were increasingly being cited as contributing to the difficulties of the relatively few (at that time) S&Ls classified by the Federal Home Loan Bank Board as problem associations. Back in 1977, about 28 percent of the

81 identified problem institutions had service corporations that contributed to their problems. This was up from 25 percent (of 83 problem institutions) the previous year and 16 percent (of 63 institutions) the year before that.

More recently we reported on risks associated with bank holding companies. In 1981 we issued a report on improving the efficiency of bank holding company examinations (called "inspections"). We noted that 15.7 percent of the companies with nonbank subsidiaries experienced problems, while only 6.2 percent of the companies without nonbank subsidiaries had them, as reflected in a Federal Reserve holding company condition rating system. These figures were corroborated by Federal Reserve holding company inspectors who told us that nonbank subsidiaries, especially credit-extending ones, present a significant risk to their bank holding companies.

Risks created by a firm's opening new lines-of-business can be successfully managed. However, since banks are thought of as "special" and since public confidence in the financial system is important, the Congress should carefully reassess the need for restrictions on banks' lines-of-business before making legislative changes.

Congress has sought to prevent overconcentration of power

Our Nation has historically been against the overconcentration of financial power and has favored full and fair competition. Major bank and bank holding company legislation since 1933 has clearly demonstrated congressional concern that banking and nonbanking businesses be separated not only to circumscribe the risks that banks could take but also to prevent overconcentration. But one of the most significant changes taking place is, in fact, a conglomeration of previously separate financial businesses with both banks and nonbanks forming business combinations that make incursions into both of these previously separated territories.

Some of the latest public hearings that dealt at length with this issue were those held during the congressional deliberations over the 1970 amendments to the Bank Holding Company Act. During those hearings the Congress was told of anti-competitive practices that could occur if bank holding companies are not restricted in their lines-of-business. One example, which I believe was reiterated to this committee in last week's hearings, was the tying by banks of their lending and insurance functions, influencing customers applying for loans to take out insurance through the banks or their affiliates.

Of course, as you reminded everyone, Mr. Chairman, incursions by insurance companies, brokerage firms, and other nonbanking organizations into banklike businesses can present the same concentration concerns. Witness the conglomerations that I mentioned earlier.

Some have asserted that financial industry competition can be enhanced by allowing more firms to offer similar services. Earlier this year, FDIC Chairman William Isaac told this committee that he favors allowing banks or their affiliates to engage in such activities as securities, real estate, and insurance brokerage; various forms of insurance and securities underwriting; and real estate development. He stated that he believed the general public would benefit by having more services offered at competitive prices, and since then FDIC has proposed policy changes to implement this statement.

The question of how the financial industry changes affect overall market competition is obviously complicated. Although we have not analyzed this issue in depth we intend to do so and will report on it to the Congress.

Varying degrees of investor protection cover similar products

Earlier I expressed concern that the merging product markets are creating gaps or overlaps in protections for depositors and investors. I would like to elaborate on this point because I feel that it is important.

I believe that the variety of competing products now being offered can confuse consumers, especially small depositors, who have a variety of investment motives. And beyond this, I believe that the sometimes subtle differences in the protections covering those products can also be confusing. Finally, it is possible that the most basic protection offered bank customers, deposit insurance, could be undermined by changing the risks assumed by depository institutions.

We have recently completed a study that describes the differences in these protections--onsite examinations, disclosure of information, and insurance--for the depository, securities, and commodities industries. We found that differences in regulation exist in (1) the degree to which regulators manage intermediaries' risk exposure through geographic and product line or asset and liability restrictions, (2) the policy of direct supervision of intermediaries versus reliance on self-regulatory organizations for this function, (3) the amount and types of information required to be disclosed to the investing public, and (4) the extent to which regulators impose restrictions on or establish criteria for advertisement of intermediary services.

Financial industry regulators have also adopted different approaches to protect investors from loss. Depository institution regulators are primarily concerned with the safety and soundness of the institutions they regulate and generally protect investors by providing account insurance. Commercial bank trust departments are supervised by the appropriate Federal and/or State regulator primarily to determine whether fiduciary standards are being observed for the purpose of protecting the customer and the institution. Trust assets are not insured unless the funds are invested in insured deposit accounts or held in bank accounts as uninvested trust funds. These accounts are, however, subject to the same insurance limitations as all other accounts.

Securities and commodities industry regulators provide protection through such methods as public disclosure and maintaining orderly markets. Securities industry investors are protected against losses not related to market conditions when a brokerage house enters into insolvency. There is no insurance of commodity investors' accounts.

Variances exist between Federal insurance programs for depository institutions and the Securities Investor Protection Corporation (SIPC) coverage for securities investors. The most important difference is that deposit insurance covers all losses related to an institution's insolvency, up to $100,000 per account, while securities investors are only protected against the loss of cash and securities held by the brokerage house should it fail or become insolvent. This protection extends only to the return of cash and securities to customers and not to losses incurred from market transactions. Federal deposit insurers also have broader regulatory and supervisory powers than the SIPC and thus are in a better position to reduce the risk to their insurance reserves and assist troubled institutions.

Let me illustrate what these variances might mean to small depositors or investors. I noted earlier that banks, savings and loans, and money market mutual funds offer similar deposit-like products in which customers may place even modest amounts of money. If, for example, a bank or S&L became insolvent, deposit insurance would generally cover each account up to the $100,000 maximum. However, if a mutual fund suffered a drastic drop in the value of its investment portfolio, the value of investors' shares would also drop, but no comparable insurance would cover the investors.

Deposit insurance also helps prevent bank failures by discouraging "runs" on banks that have financial problems. If investors lose confidence in a money market mutual fund, no similar insurance would decrease the likelihood of a run on it, nor, in a worst case scenario, runs on several funds with comparable investment portfolios.

Depositors and investors make decisions on where to place their money for many reasons, and it is not easy to associate specific flows of funds with specific motives. However, available data can demonstrate that consumers do shift funds readily in response to market changes and therefore could face some confusing comparisons for similar products. Offering checkwriting features and interest rates higher than the regulated rates in depository institutions, money market mutual funds grew enormously in the late 1970s and early 1980s, reaching a peak of about $240 billion in late 1982. These funds increased their market share of financial assets from 0.1 percent in 1976 to 4.4 percent in 1981. At the same time, depository institutions suffered a slight loss of market share, from 62.9 percent to 58.4 percent, much of it attributed to outflows to the money market mutuals.

Things changed dramatically after the Garn-St Germain Act allowed depository institutions to offer money market deposit accounts (MMDAs) to compete with the mutual funds. The MMDAs began by offering higher interest rates than the funds (though the rates have since dropped). MMDAs were also covered by deposit insurance. According to the Federal Reserve, the MMDAs grew to $320.5 billion from their introduction in December 1982 through March 1983. Correspondingly, assets in money market mutual funds dropped $44 billion to a total of

$197 billion. A good portion of this drop went to the depository institutions' MMDAs--estimates from various sources range from $30 billion on up.

While exact motives for the money movements cannot be associated with specific amounts, it is clear that many consumers have exhibited preferences for both higher rates of return and a higher degree of protection. That is why I think that the variances in investor protection, coupled with the variety of risk/reward alternatives offered in today's market, can confuse the average financial services customer.

New strains on traditional deposit insurance

The most basic protection afforded small savers is deposit insurance, providing a virtually risk-free investment product. However, as we testified before this committee on October 30, 1981, new products offered by depository institutions which involve different risks may put new strains on traditional deposit insurance.

Deposit insurance was developed at a time when policies regarding competition, lines-of-business, and interest rates could successfully remove much of the risk from banking or thrift institutions. In this environment, FDIC and the Federal Savings and Loan Insurance Corporation (FSLIC) were able to minimize insurance payouts to depositors by assisting orderly mergers or purchase and assumption transactions of failing institutions.

Now, however, new risk[illegible]or the depository institutions may mean that more of them could require assistance from the insurance funds or that payouts could increase. Acknowledging the potential increase in risk to insurance funds, FDIC Chairman Isaac has suggested changing the insurance program to incorporate

--premiums adjusted to the risk of each institution,

--coinsurance for deposits greater than $100,000, and

--modified payoffs to depositors in failed institutions.

The role, structure, and financing of deposit insurance will have to be carefully considered in formulating a new regulatory environment. Even the Federal insurers appear to have differing views on this subject, judging from their studies recently submitted to the Congress as required by the Garn-St Germain Act. These differing views and the importance of the role of insurance have prompted us to study the deposit insurance programs, including alternatives to the current insurance arrangements, so we can assist the Congress as it considers proposed changes. We intend to do this by looking at

--the current operations of the funds as compared to their established purposes,

--staffing and other costs of administering the funds,

--agencies' fund investment practices,

--benefits and problems of consolidating the funds, and

--the ramifications of deregulation on the funds.

Again, we hope to be able to provide useful information to the Congress on these matters later this year.

MANY REGULATORY STRUCTURE ALTERNATIVES EXIST

Once the Congress has a better idea of where the market is headed, and after the need for various restrictions has been reevaluated, alternative regulatory approaches can be studied. The restructuring of Federal financial industry regulators has been debated for many years. In the past, the call for restructuring was based on perceived inefficiencies and lack of coordination among the depository institutions regulatory agencies. Now, though, the debate also focuses on the market changes that may render inappropriate the current structure for regulating all financial industry activities.

Efficiency, coordination issues have been addressed inconclusively

Many studies have been made in the past about restructuring depository institutions regulation to make it more efficient, effective, and consistent. Although possible improvements in efficiency have been cited, the case was never made strong enough to effect changes. The Congress tried to improve the coordination among the depository institutions regulators by creating the Federal Financial Institutions Examination Council (Council) in 1978. But although the Council has achieved some worthwhile accomplishments, we do not believe that it can totally fulfill the greater objectives set for it by the Congress because the member agencies are still divided on key issues.

As I said, many studies have been made just of the question about restructuring depository institutions regulators. We summarized the arguments, pro and con, in a report issued in 1977 on debate over the restructuring question to help the congressional deliberations then taking place. The arguments in favor of consolidating the agencies were that consolidation would

- --increase the effectiveness of handling problem or failing banks,
- --increase the effectiveness of dealing with bank holding companies,
- --improve the efficiency of overall regulatory operations,
- --increase the accountability of the agencies to the Congress and the public,
- --insure more uniform treatment of all banks, and
- --better integrate bank supervision with monetary policy.

The arguments against consolidation were

- --the current system was working well,
- --consolidation would centralize regulatory power and weaken the State/Federal "dual" banking system, and
- --regulatory innovation would be stifled.

At that time there were no arguments persuasive enough to undertake a major reorganization, so the Congress created the Council in the Financial Institutions Regulatory and Interest Rate Control Act of 1978 to accomplish some of the efficiency and uniformity objectives.

The Council's purpose was to prescribe uniform principles, standards, and report forms for the Federal examination of financial institutions by the Office of the Comptroller of the Currency, the FDIC, the Federal Reserve System, the Federal Home Loan Bank Board, and National Credit Union Administration, and to make recommendations to promote uniformity in their supervision of financial institutions.

In a report on the Council that we will be issuing in a few months, we conclude that the need for uniformity in the supervision and regulation of depository institutions is as great or greater today than it was when the Council was established. One of the Council's most important projects, a Study of Examination Philosophies, Concepts and Procedures, was not able to reconcile differences between agency examination policies. The examination process is the heart of depository institutions supervision. Although the Council has taken 11 actions to establish uniform examination principles, standards, and report forms, we found that these actions did not result in significant progress toward uniformity.

In 1981 we reported on ways to improve the Federal structure for examining depository institutions. We recommended that the Council prepare a plan to have the Federal regulators share examination workloads and study the feasibility of consolidating agency examination staffs. The Council and its member agencies disagreed with our recommendations, citing a number of philosophical and organizational problems. While we agreed that some problems existed, we still believed that opportunities existed for improved efficiencies.

So in light of the inability of the Council to reach its congressionally mandated objectives, we will be suggesting that an alternative to the presently structured Council is needed. Possible alternatives include

--modifying the present Council to make its policies mandatory and give it a permanent staff,

--establishing a common examination force, or

--consolidating the depository institution regulators.

Market changes now also drive consideration of regulatory structure changes

Many suggestions have been made for a new regulatory structure based on the changing markets, but the alternatives seem to fall somewhere in the spectrum between regulating institutions regardless of the products they offer (the current structure) or regulating products regardless of who offers them. The latter has attracted much interest, but I can envision that this product orientation form of regulation, given the multiproduct organizations that are developing, could have its drawbacks. For example, an organization like Sears that offers a full range of financial products would find itself dealing with several different regulators under that alternative.

Those who propose a product-line oriented, or functional, regulatory structure, argue that now, with different institution-oriented agencies regulating similar products, the regulatory treatment of these products could differ. In the competition of the financial marketplace, these differences could become critical if they create advantages for some businesses over others. For example, as pointed out in a recent Conference on Major Issues Confronting the Nation's Financial Institutions, mutual funds, commodity pools, and common and collective trust funds serve similar functions. However, because of their historical origins they are regulated respectively by the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the banking regulators under widely differing disclosure, advertising, and conflict of interest rules. We have a job underway now comparing the regulation of some of these services which we will be reporting on next year, and which I think will help lay the basis for a detailed, yet organized, understanding of whether product-line regulation is needed.

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As I mentioned earlier we are now conducting or will be starting a number of studies to help the Congress evaluate this and other regulatory structure alternatives. The overall question that will drive these studies is, "What type and mix of regulation and oversight is appropriate for each type of investment risk to assure adequate protection to investors?" The basic protections--insurance of investor funds, onsite examinations, and disclosure of information--can be altered and combined in a variety of ways to suit particular products or institutions.

Consequently, we will study, in a series of jobs

--the changes in and direction of the markets;

--the effect these have on the current regulatory structure;

--the role and structure of the various regulatory tools, including the best ways to assure adequate protections for depositors and investors;

--the nature of the risks involved with various product lines; and

--the strengths and weaknesses of alternative regulatory structures.

Although we intend to report periodically on the results of these studies over the next 2 years, we expect, as I mentioned earlier, to be able to offer valuable information to the Congress in the interim.

Mr. Chairman, that concludes my statement. We would be happy to respond to any questions you or other Committee members might have.

The CHAIRMAN. Your entire statement will be included in the record, and once again I apologize to you and the other witnesses for having to leave, although it is rather remarkable what we are doing.

Most years we don't even get to appropriations bills before August. As a matter of fact, last year the House didn't even send us any appropriations bills before August. They have actually done some work this year, and we have four that have come over from the House of Representatives, and Chairman Hatfield has vowed anything the House sends us we will act upon promptly.

So we have actually reported out already this week one appropriations bill. This will be the second one.

So I hope you will understand the necessity to try and avoid another continuing resolution. We will not—we will have one in October, in any event, but at least we are doing a better job than in most years.

So I will turn the committee over to my able colleague from Nevada and again express my apologies to all of you for having to leave.

Senator Hecht.

Senator HECHT [presiding]. Thank you, Mr. Bowsher.

Today, as Senator Garn mentioned, we are celebrating the 50th anniversary of the Glass-Steagall Act. Let us say that Mr. Glass and Mr. Steagall did like Rip van Winkle and went to sleep for 50 years. They woke up this morning, and they see and hear testimony for the last 2 or 3 months that banks now sell insurance, have title companies, sell real estate, have their own development companies.

We hear from people from the FDIC that no longer do they feel that accounts should be insured up to 100 percent. We have everyone—not everyone, but so many people taking in deposits.

How do you think they would relate to that this morning?

Mr. BOWSHER. I think they would be concerned, as we are concerned, about the depositors and their protection because I think, as our studies have shown in the past, that when some of these institutions get into different lines of effort, they are not as successful as they thought they might be.

I think, also, with the problems that are facing the banking industry and some of our financial institutions here—not to have adequate deposit protection on all deposits and the fact that now you have a lot of deposit—like funds outside of the traditional banks—I think is a fairly scary situation.

Senator HECHT. In your testimony, on page 2:

> After the collapse, Congress created in 1933 and 1934 regulations and protections to restore public confidence in the financial system and promote the orderly intermediation of savings to investment.

Are these same laws still important today?

Mr. BOWSHER. Well, we think they are. We think, also, though, that things have moved so fast here in the whole financial services industry that we do believe that Congress has to look at it again.

That is what you are doing, of course, and we commend you for doing that, because there is no question that the laws and the regulations and the protection devices today are in place, pretty much based on what was in place there in the 1930's.

And now there have been so many changes, and people in the industry are saying they want to make more changes, that we just feel that you have to take a very close look at this whole area. That is why we are going to be doing the work that we plan to do and try to be of service to the Congress on some of these issues.

Senator HECHT. Specifically, what changes would you endorse at the moment?

PROBLEMS OF AUDITING FUNCTIONS IN FINANCIAL SERVICES

Mr. BOWSHER. We feel we would sooner do more of the work that we are planning to do before we come out with specific recommendations. One of the things we will be looking at is whether one consolidated regulatory unit, you might say, should be auditing all these services.

We think there are many problems. We reported over the years the problems of the various overlaps and gaps of the present regulatory and auditing functions in financial services, and we think that is an area that should be given a lot of thought. And we would like to finish our work before we come up with specific recommendations.

But our concern is that the present structure cannot do the job with the existing industry out there.

Senator HECHT. But as of the moment you have nothing to recommend until you do further studies?

Mr. BOWSHER. We would prefer to do the further studies before we came up with a recommendation.

Senator HECHT. Senator Gorton.

Senator GORTON. Thank you, Mr. Chairman.

Mr. Bowsher, comment, if you will, on the proposed regulations of FDIC which are going to allow State-chartered nonmember banks to engage in certain securities transactions prohibited to federally chartered banks, on two levels if you will: First, your feeling as to their desirability versus their riskiness; second, as they affect your comments on the urgency of consolidating our Federal regulation in a single entity so that we could make broad general decisions rather than differentiated and fractionated decisions under the present system.

Mr. BOWSHER. Well, I think that the regulations that allow this, of course, raise the issue that was there some years back about the added risk. In other words, if you are going to allow the banks to be in the securities business, you are going to have an additional risk that wasn't there before when the banks were primarily in a depository industry with fairly good protections.

Now, I think one of the problems you have in the regulatory end today is, again, there are more and more lines of business. How do you audit? How do you regulate these?

And I think that Chairman Shad of the SEC has come out for a product line audit, or regulation, and I think that should be looked at.

But I think that does give you the problem of sending in additional teams and additional Federal audit groups to one firm. And one of the big concerns here is, I think, when you look at some of these problems that we have had with some of these bank failures, you see people moving assets among various business. You see people moving loans around and paper around to try to beat the regulations.

I mean, there is an article in today's paper about Penn Square and Seattle First out there, where apparently one of the officers said they were moving loans like that.

One of the big principles in auditing is to audit all the functions so you get your hands on everything that happened.

One of the problems with the C. Arnholt Smith bank failure in San Diego some years back was that he had different auditing organizations looking at different parts of his empire, and no one group ever saw the total. Therefore, things got moved and no one caught hold of it.

And from what I can read in the newspapers and understand what happened out in Knoxville, there is some element of that down there.

So I think as we look at this overall line of effort and things like that, one of the things that has got to be given a lot of serious consideration is can the regulatory people and can the auditors look at the entire operation so that people can't be moving securities and paper and things like that that allows these kind of things to happen and not have any advance notice of it.

Senator GORTON. One more followup question. Assistant Attorney General Baxter characterized the moratorium—and I am quoting—"as putting fingers in a crumbling dike that should be allowed to crumble."

Do you feel that it is even possible for the Congress effectively to control financial institutions in the face of the high degree of imagination and cleverness which their managers have engaged in over the last few years and are likely to continue?

Mr. **Bowsher**. I think it is much more difficult under this kind of an environment than it was for 30 or 40 years, but I think also the fact that it was done for 30 or 40 years fairly successfully with legislation from the Congress is something that cannot be ignored either. So I think that the Congress has to look at what has happened, has to look at what they think the market changes are going to be.

LEGISLATIVE CHANGES INSTEAD OF A MORATORIUM

Specifically on the moratorium, I have a lot of sympathy for an idea of let's stand still for a while and get this thing straightened out, but I think it is very hard to do it practically. In other words, I think a more practical solution might be for the Congress to work with all deliberate speed, you might say, and come up and make whatever changes it feels are necessary.

Senator **Gorton**. I take it that your answer is that if we decide what we want to control and how we want to control it that we can devise a statute which would be effective?

Mr. **Bowsher**. I think that would probably be a more practical approach than trying to put a moratorium through legislation and trying to control things and then do the second thing.

Senator **Gorton**. Thank you, Mr. Chairman.

Senator **Hecht**. Senator Lautenberg.

Senator **Lautenberg**. Mr. Bowsher, I am sorry that I didn't hear the presentation of your testimony, but if any of this is redundant, please forgive me. I just want to be certain that I understand the focus of your attention.

I heard you just respond to Senator Gorton and say you thought we ought to proceed with all deliberate speed in the process of not having the moratorium.

Do I understand you correctly? You would like not to bother with the moratorium?

Mr. **Bowsher**. Let me say I have sympathy for the idea of the moratorium. In other words, when Paul Volcker says "Boy, we have got to take a broom to the place and try to sort this out," it would be good. I have a lot of sympathy for that, but I worry about the practicality of achieving that moratorium and the fact that you have to do it through legislation, and I think what might be better to do is just hold hearings, look at the issues, and possibly come forward with the legislation, or legislative changes that you feel necessary to solve the basic problems.

Senator **Lautenberg**. Sympathy usually follows in the wake of a fatality, and I wonder whether we are looking at something that is already dead. Your tone of sympathy indicates that it is really an accomplished fact.

Mr. **Bowsher**. There is a lot that has been accomplished, and it is moving fast, and I think you just kind of look at the industry as it is today and see how you feel it should be regulated.

Senator **Lautenberg**. Without retarding progress, I guess the question of should we regulate, shouldn't we regulate is almost past. It is a question of pace. It is a question of who is allowed to get onto the playing field, to use a popular expression.

Can you see any value to keeping out other kinds of companies, defined in loose terms as nonbanking, who might bring added capital to the marketplace, which everybody talks about as being hopelessly inadequate for our needs today?

Do you see a value to letting those people come in, whether it is insurance companies or otherwise? They have capital, many times an abundance of capital.

Mr. BOWSHER. I think having a proper open approach that allows people to come in has a lot of merit, but I think the real thrust of our testimony is that I worry about it happening and there being gaps in deposit protection and in regulation—whatever regulatory approach you want.

In other words, I think—as I illustrated in one of my statements here—that when we create a new set of depository options for the consumer, let's say as the security industry did, I worry that some of those do not have the same protections that some of the other depositories do. The same with the regulatory thing.

So it is the gaps and the overlaps that is my main concern here.

Now whether another group should be allowed on the playing field, as you described, we have not done any studies on that.

Senator LAUTENBERG. The whole question of protection goes back to the relatively secure depository mechanism. For a lot of years it worked very well. I think there is a reason to ask the question as to whether someone who takes an investment—takes money to invest as opposed to deposit, is entitled to the same protection as the depositor.

If the money goes into the stock market, one takes the risk. You look for the return. That is the ball game.

That is the thing I have been most concerned about in this process, and because I am new here and there's lots of hard work done by esteemed colleagues over a lot of years, I at times feel like I am stepping unfairly on toes that have kicked a lot of footballs around here.

But nevertheless, what I sense out of your testimony is a concern that the velocity or the flight of capital to various new opportunities does deprive the individual borrower, the homeowner for instance—a critical business and a critical environmental theme for our society—people talk about the aspiration of having one's own home, and that is an ideal for lots of people, but now as we compete in the marketplace with other higher yielding instruments, I wonder what protections they are entitled to. Should they be taking the risk?

Your responsibility in terms of—you talk about it from an auditor's standpoint—is that your professional background?

Mr. BOWSHER. Yes, it is.

Senator LAUTENBERG. I am a would-be auditor, having been in the computer business and having responsibilities and having sat on bank boards and insurance boards.

Do you think they're entitled to the same kinds of protection?

DIFFERENT INSURANCE PROTECTION

Mr. **Bowsher**. I think there should be a difference in the protection between the investor who's taking a market risk, you might say, and the one who's putting deposits in to just get a return on that deposit and wants a lot of safety.

My concern is that as we bring new players onto the field, some of their services are more in the depository area and some are more in the high-risk area.

What I'm concerned about is, some of these products such as the money market and depository accounts in a brokerage house do not have the same insurance protection as, say, a person who's put it into a depository account in a thrift or a bank, and I'm not sure the consumer understands all that.

In other words, everyone is throwing out the fact that they've got insurance, but if you read in the Wall Street Journal today about that account where the WPPS thing is suddenly coming unglued out there in the Northwest and some of the bondholders have some insurance with Baldwin, another company that's having some trouble, I'm sure those people were probably told that their bonds were insured. The question is who is the insurer.

So we have different forms of insurance, and I think the Congress ought to take a very good look at these various insurance protections for like types of investments.

In other words, I don't think a person taking a high risk investment should have the same depository insurance from the taxpayer. The people that want to get their money in and get 5 percent, 8 percent, or whatever the market is paying at the present time, I worry that they're putting it in a different place, think they've got some insurance and it turns out maybe it's quite different than what they would have if they went somewhere else.

Senator **Lautenberg**. Do you think that we'd be wise in the Congress to undertake a restructuring of the legal framework of the financial services industry?

What I'm concerned about, frankly, is not so much who comes into the business. I think if the rules are clear then everybody will play by the same rules, the risks are the same, capital risks, the legal risks. I worry about the variety of products.

I found out the other day that I sat there 12 years ago, 13 years ago, where you sit as an officer of the computer industry association. I was then concerned about the kinds of services that the banks might be offering, and I'm still concerned about that.

If the definition of the bank's responsibility is to provide capital to individuals as well as businesses and now it looks more like we're competing in the securities industry on high-risk business, a kind of crapshooting thing. If you want to shoot craps, you're not entitled in my view to the same protections.

Is there anything that you see doing other than that which has taken place in front of our eyes. That is, an accelerated move toward deregulation and let the chips fall where they may?

Mr. **Bowsher**. I don't think it should just be let the chips fall where they may and just accept complete deregulation without a good bit of study and a lot of consideration by the Congress.

One other thing that worries me primarily from my background before I came into government—and you touched on it, Senator—is the capability of these institutions that keep going into dfferent lines. In other words, do they have the capability to be in the computer business? Do they have the capability to be in the securities business?

When everybody rushes out into all these new lines of effort, that means everbody's got to go out and get a lot of very talented people on board and we all know that you only are successful a certain percentage of the time as you select different people for different lines of effort that you haven't been in in the past.

So I think there's an element of risk here as we move in, and one of the studies we did a few years ago pointed that out. The ones that have problems lots of times are the ones that have rushed into all these different lines of effort.

And again, I think the public and the Congress should think through all that and see if the public is being given adequate protection, not for the high-risk investments—people that go into that have to take their risks. But I think when they're putting money into deposits, when they're putting money into what they consider and what is really being sold to them as a fairly safe investment, something they're not going to double their money on in a short period of time but they're going to get a certain rate of return, that should be properly regulated and there should be some proper insurance protection.

That worked very well in this country over the last 50 years.

Senator LAUTENBERG. Thank you, Mr. Chairman. If I might make just one more observation here, that is, that the definition of high risk escapes, I think, some very innocent investors, that is, they don't understand, I think in many cases, that when one searches for the maximum return, whether it be a dividend or an interest-bearing instrument, that they are then getting into a loftier atmosphere, and I think it's been a mistake over the last years to have people, a lot of people who don't have the ability to deal with this. But we're looking at money market funds and things of that nature and say "there's no risk here."

There is risk there, and I hope that one day this statement doesn't get proven, but the fact is that once you're competing out there for top return, whether again it's interest or dividends, the risk is essentially the same.

But people are lulled into complacency about that because they think it's associated with a bank or financial institution. We're going to have to do something about that before a failure forces us to bail out a bunch of people who aren't entitled to be.

Thank you.

Senator HECHT. Thank you, Senator Lautenberg. Thank you, Mr. Bowsher and your associates. We're going to move right along now to Mr. K. Houston Matney. Mr. Matney is the securities commissioner of the State of Maryland and chairman of the financial institutions committee of the North American Securities Administrators Association.

We're glad to have you today. Please continue.

STATEMENT OF K. HOUSTON MATNEY, SECURITIES COMMISSIONER OF THE STATE OF MARYLAND AND CHAIRMAN OF THE FINANCIAL INSTITUTIONS COMMITTEE, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, ACCOMPANIED BY MARIANNE E. ROCHE

Mr. MATNEY. Thank you, Mr. Chairman. NASAA welcomes the opportunity to be here this morning to address these topics from the perspective of the State securities regulatory agencies.

I would like to add preliminarily that we have both individually and as a group tried to respond as quickly as possible to the developments in the financial revolution.

Our first major involvement was just about a year ago with the Invest program for the savings and loans, which was about to come into existence. I believe that we played a pivotal role at that time in formulating the regulatory response to this kind of activity, both at our level and to a certain extent at the Federal level.

We prepared a comprehensive report last fall surveying all the developments at that time and pointing out the implications that we saw at both the State and Federal level in the investor protection provisions of the securities laws.

Copies of that report will be made available to the committee; in addition, we sponsored in January of this year a 2-day financial institutions forum where we brought together the State securities administrators, representatives of other Federal and State regulatory agencies, and members of the securities, commercial banking, and insurance industries.

I would point out that Danny Wall the staff director of your committee played a key role in that forum and to a very large extent helped us formulate a timely response to these issues.

[The following reports were submitted for the record:]

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September 24, 1982

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TO: David Hart Wunder, President
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FROM: K. Houston Matney, Chairman
Committee on Financial Institutions
and Legislation Committee

Re: Committee Report

At a recent meeting of its Board of Directors, NASAA created an ad hoc Committee on Financial Institutions (the "Committee"). The Committee charges are:

1. To monitor the current redefinition of the boundaries between the banking and securities industries, with particular reference to: (a) federal legislation such as the "Depository Institutions Amendments of 1982" and certain proposed amendments to the Glass-Steagall Act; (b) federal regulatory initiatives such as the Federal Home Loan Bank Board's proposed rules permitting savings and loan service corporations to engage in securities and commodities activities; and (c) the wide variety of investment "products" now being offered by depository institutions, either acting alone or in conjunction with brokerage firms;

2. To assess the impact of these developments upon existing schemes of state securities regulation; and

3. To define the policy concerns implicit in these developments and to recommend appropriate statutory and administrative changes at the state level.

The Committee's first action was to submit a letter of comment to SEC Chairman John S. Shad on a request by an S & L service corporation, Savings Association Investment Services, Inc. (SAIS), for a no-action letter with respect to SAIS's planned entry into the brokerage business. A copy of that letter is attached as Appendix I. That experience impressed upon the Committee the need to respond quickly and in an informed manner to fast-moving market and regulatory developments. Accordingly, the

Committee met (together with certain representatives of the Legislation Committee) in Boston on September 9-11, 1982, for the purpose of gathering more information and setting a course of action. In addition to reviewing recent developments, the Committee met with representatives of the Investment Company Institute and of Fidelity Brokerage Services, Inc., who each described the state of the problem from their own perspectives.

The following report is designed to serve two purposes: (a) to describe very generally the pattern of events unfolding in Congress, the federal agencies, and the market, with respect to both the development of new securities products and the expansion of bank financial services; and (b) to propose a framework for NASAA response to what is, in essence, a financial revolution. The report will begin, however, with a brief description of the pertinent sections of the statutory framework.

I. THE STATUTORY FRAMEWORK

A. The Securities Act of 1933 and the Securities Exchange Act of 1934

(1) Registration of Broker/Dealers

Section 3(a)(4) of the Securities Exchange Act of 1934 (the 1934 Act) states flatly that the "term 'broker'" means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." Banks are similarly excluded from §3(a)(5)'s definition of "dealer". "Bank" is defined by §3(a)(6) as follows:

> The term "bank" means (A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (C) any other banking institution, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under section 11(k) of the Federal Reserve Act, as amended, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions o this title, and (D) a receiver, conservator, or othe

> liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

The 1934 Act does not, however, state explicitly whether an institution shall be treated as a "bank" for purposes of exclusion from the statutory definition of "broker" and "dealer". In fact, the SEC specifically refused to conclude that a savings institution participating in the SAIS program could not be a "broker" within the meaning of section 3(a)(4), and in fact found that such savings institutions would be a "person associated with a broker" within the meaning of section 3(a)(18) with respect to brokerage activities conducted on their premises. SEC No-Action Letter, SAIS, July 8, 1982 (current) Fed. Sec. L. Rep. ¶77,228 at 78,009. See also SEC No-Action Letter, Southwest Savings and Loan Association, (1974-75 Transfer Binder) Fed. Sec. L. Rep. ¶79,988 at 84,545. The possibility remains, therefore, that an S & L engaged in brokerage transactions may be compelled to register as a "broker" under section 15(a)(1), or that such a savings institution may be subject to SEC censure under section 15(b)(a) as a "person associated with a broker."

Section 3(a)(4)'s exclusion, furthermore, has typically not been extended to bank service corporations, bank holding companies and non-banking affiliates which engage in brokerage activities. See e.g. SEC No-Action letter, Georgia Company, (1973 Transfer Binder) Fed. Sec. L. Rep. ¶79,540 at 83,474.

While the 1934 Act thus substantially excludes banks from its broker registration provisions, the further entry of banks and savings institutions into the brokerage business may lead to narrower definition of "bank" under section 3(a)(6), and broader application of section 3(a)(18)'s "associated person" concept. In other words, amendment or interpretation of the Glass-Seagall Act to permit banks to function as brokers may require some re-thinking, at the federal level, of the exclusion of banks from the 1934 Act's definition of "broker".

2. Registration of Bank Securities

Section 3(a)(2) of the Securities Act of 1933 defines as an exempt security:

> any security issued or guaranteed by any bank; or any security issued by or representing an interest in or

> a direct obligation of a Federal Reserve bank; or any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian.

Section 3(a)(2) goes on to define "bank" as follows:

> the term "bank" means any national bank, or any banking institution organized under the laws of any State, territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official; except that in the case of a common trust fund or similar fund, or a collective trust fund, the term "bank" has the same meaning as the Investment Company Act of 1940.

Since this definition of bank does not include savings institutions, a separate exemption for securities of those issuers is provided in section 3(a)(5) for:

> any security issued (A) by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution, except that the foregoing exemption shall not aply with respect to any such security where the issuer takes from the total amount paid or deposited by the purchaser, by way of any fee, cash value or other device whatsoever, either upon termination of the investment at maturity or before maturity, an aggregate amount in excess of 3 per centum of the face value of such security....

These exemptions are, of course, only registration exemptions. Banks and savings institutions may be liable for fraud in connection with transactions in their securities under section 17(a) of the 1933 Act and section 10(b) of the 1934 Act, and savings insitutions may face liability under sectin 12(2) of the 1933 Act. Securities issued by banks and exempted from registration under §3(a)(2) are, however, specifically excluded from the purview of section 12(2).

The recent development of novel bank financial products, however, has generated some certaintainty about the continuing effectiveness of this regulatory scheme. For example, the growing use of retail repurchase agreements ("retail repos") by both banks and savings institutions, has created some concern at the SEC. The SEC has taken the position that retail repos are debt securities exempt under section 3(a)(2) or section 3(a), but has also emphasized the need for the issuer

> "to comply with the disclosure requirements of the Federal securities laws as well as the specific disclosure guidelines of federal and state regulatory agencies. Although retail repos are exempt from the securities registration provisions of the Securities Act of 1933, they are not exempt from the antifraud provision of that Act or of the Securities Exchange Act of 1934." SEC §21(a) Report on S & L Retail Repo Sales, No. 34-18927 (July 30, 1982), 14 Sec. Reg. & L. Rep. (BNA) 1414, (August 6, 1982); See Also SEC Interpretive Release No. 33-6351 (September 25, 1981), 1 S. Reg. (P-H) ¶1851.2.

The nature and techniques of compliance with the disclosure requirements of the federal antifraud provisions, however, will need further definition. For an example of one state's position on repo agreements see Maryland Securities Division letter of August 4, 1981 attached hereto as Appendix II.

Retail repos, of course, are not the only source of concern. The new bank products described below in our discussion of "Market Developments in the Bank Securities Area" will also place some pressure on this aspect of the federal regulatory scheme.

B. The Uniform Securities Act

1. Registration of Broker/Dealers and Agents

Section 401(c) of the Uniform Securities Act ("USA") defines "broker/dealer". That definition contains an exclusion for "a bank, savings institution, or trust company". Accordingly, both state and national banks, as well as savings institutions, are exempt from the broker/dealer registration requirement of section 201 of USA. Exempted under the same provision are independent trust companies: entities which do not accept deposits, but which are regulated by state banking commissions.

While the Official and Draftsman's Commentaries are not clear, a review of the over-all exemptive scheme indicates that the term "savings institution", for purposes of section 401(c), does not include savings and loan institutions or credit unions. A "savings institution" under section 401(c) refers only to the mutual savings banks found in the northeastern states. Mutual savings banks, like commercial banks, accept depository accounts, but they are formed and regulated under different state statutes. The Dime Savings Bank of New York and the Boston Five Cent Bank are examples of such institutions. Mutual Savings banks do not exist west of Ohio except in the State of Washington.

It may be argued that the section 401(c) exclusion contemplates that these institutions will fall within section 401(b)'s definition of an agent when ever they act as the common law agent of a broker/dealer as, for example, in the Fidelity Discount Brokerage Program described below. Section 401(b) makes clear, however, that a corporation, as distinct from a natural person, may not be a statutory agent: an "'agent' means any *individual*." Any enforcement action would thus have to be taken against the individual employees of the institution, since they may be characterized as common law sub-agents of the registered broker-dealer, and, as such, required to register as statutory agents of the broker-dealer. *See* sections 401(b) and 201(a). While it has generally been *assumed* that the bank's exemption under Section 401(c) extended to its employees, nothing in the language of the statute compels this conclusion. Furthermore, the Official Comment to Section 401(b) suggests that treatment of bank employees themselves as broker-dealers under Section 401(c) is possible.

Section 401(c)'s exclusion of banking institutions from the definition of broker-dealer was derived largely from the similar treatment of such institutions under the 1934 Act, and thus reflects similar assumptions about the purpose and effect of the Glass-Steagall Act. "The exclusion of banks from the Exchange Act's definitions of 'broker' and 'dealer' must be read in conjunction with the provisions of the Glass-Steagall Act." Wolfson, *et al.*, REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS, p. 1-24 (1977). To the extent that the Glass-Steagall Act's restraints on banking securities activities are loosened, the premises of section 401(c) will be undercut and the need for rethinking will arise.

2. Registration of Securities

Sections 402(a)(3), (4) and (6) exempt from registration securities issued by certain financial institutions. Section 402(a)(3) exempts the securities of banks, independent trust companies, and savings institutions (i.e. mutual savings banks) organized *and* supervised under the laws of the United States or any state. Hypothetically, therefore, a New York bank could sell its securities without registration in another state even though the New York bank was not authorized to engage in the banking business in that ~ther state. Section 402(a)(4) similarly exempts the securities of state or federal savings and loan associations. Here, however, the savings and loan associations, if a state institution, must be authorized to do business in the state. A Texas savings and loan association, therefore, could not sell unregistered securities in Oklahoma unless also authorized to engage in the business of banking in Oklahoma.

Finally, section 402(a)(6) provides an exemption for the securities of federal and state credit unions. Here, however, the credit union, if a state chartered organization, must be organized under the laws of the state before it can sell unregistered securities. Thus a Texas state chartered credit union may use section 402(a)(6) to sell unregistered securities only in Texas.

All these exemptions cover any security "issued by and representing an interest in or debt of" the financial institution, or which is "guaranteed by" the institution. Note that the first clause requires: (1) that the security be issued by the institution; and (2) constitute a debt or equity interest in the institution. It is not sufficient that the institution merely be the issuer. This requirement will be important in connection with some of the new bank security products. Note also that a security not issued by the financial institution may still be exempted under Section 402(a) if the financial institution "guarantees" the security. See also, section 401(e), which defines "guaranteed" to mean "guaranteed as to the payment of principal, interest, or dividends." The use of the disjunctive suggests that both interest and principal need not be guaranteed for the security to be exempt.

The exemptions provided by sections 402(a)(3), (4) and (6) pertain, of course, only to the registration requirements and not to the antifraud provisions of USA. Furthermore, there is no gap in the coverage of USA's antifraud provisions parallel to that under section 12(2) of the 1933 for section 3(a)(2) bank securities.

One potentially troublesome enforcement problem should be noted: Section 402(b)(8) exempts from registration "any offer or sale to a bank, savings institution, trust company" or other enumerated institutional investor. A broker-dealer may seek to circumvent

USA's securities registration requirements by selling unregistered securities to a bank purporting to act merely as the agent of a depositor, with the broker-dealer invoking the section 402(b)(8) exemption. The Missouri Securities Commissioner has recently issued a cease and desist order in connection with such a transaction. See In re Weinrich, Sitzmann & Whitehead, Inc., File No. CD 82-3 (Mo. Sec'y of State, February 24, 1982).

C. The Glass-Steagall Act

The only persons directly prohibited from complete entry into the investment banking business are banking organizations - banks and bank holding companies. The Glass-Steagall Act restricts entry of commercial banks into certain aspects of investment banking, and the Bank Holding Company Act permits bank holding companies to engage only in activities "so closely related to banking ...as to be proper incident thereto."

The securities industry carries out three functions: the raising of debt or equity capital, the maintenance of secondary market liquidity, and the provision of investment advisory services. Banks may provide a number of these services in connection with specific securities, such as securities held in trust departments and private placements, and they may purchase and sell "securities and stock without recourse, solely upon the order and for the account of, customers, and in no case for its own account...", but banks may not:

1. underwrite revenue bonds;
2. sell, distribute or manage mutual funds;
3. engage in "best-efforts" underwriting of corporate debt (note that loans with participation agreements may be seen as a form of underwriting corporate debt);
4. engage in large-scale distribution of corporate debt; or
5. underwrite and distribute corporate equity issues.

Federal law bars Federal Reserve member banks from indirectly participating in such securities activities through affiliates (either bank subsidiaries or brother-sister subsidiaries of a bank holding company), except when such activities are closely related to banking. Non-member banks, however, may indirectly participate through subsidiaries and affiliates. With the Federal Reserve Board's permission, non-member banks may so participate in holding company form.

The public policy rationales for this scheme are complex. The Glass-Steagall Act's restrictions seem to have been conceived in response to the argument that heavy bank involvement in investment banking and secondary market trading was a major cause of the Great Crash of 1929. That argument derived in part from a perception of the importance of bank stability in an economic system dependent on banks as the primary creators of money. The Bank Holding Company Act's restrictions, on the other hand, reflect a primary concern with concentration of financial resources, rather than with bank stability as such. Finally, the legislative history suggests that some bank brokerage activities should be permitted in order to allow persons living in rural areas and small towns access to the secondary markets.

The competitive challenge to bank depository functions posed by money market funds with draft privileges has created an incentive for bank re-entry into the securities industry. The market response to this incentive will thus create additional pressure on the existing federal scheme of bank regulation, and require a reexamination of the just-described policy concerns. As the next section of this report shows, that reexamination has already begun. The impact of that reexamination on the state securities administrator's vision of investor protection thus remains to be determined.

II. FEDERAL REGULATORY AND LEGISLATIVE DEVELOPMENTS

A. Regulatory Developments Concerning Bank Securities Activities

Notwithstanding the numerous legislative developments pending in Congress and described below, several of the major Federal regulatory agencies are moving rapidly to consider requests by various banks or similar financial institutions to offer securities services or products. It has been observed by some critics that the rapid pace at which these significant regulatory policy developments are occurring may render moot any action by Congress on Glass-Steagall.

Current regulatory proceedings include:

1. Issue: Commercial bank acquisition of broker/dealer

Parties: Bank of America/Acquisition of Charles Schwab & Co. (discount broker)

Status: Federal Reserve Board hearings in September; Fed must determine whether securities brokerage and margin lending are "so closely related to banking as to be a proper incident thereto" under §4(c)(8) of the Bank Holding Company Act.

2. Issue: New rules of Federal Home Loan Bank Board to permit savings and loan associations to establish broker/dealers and mutual funds

Status: Approved by FHLBB May 6, 1982; *see* summary, 14 BNA Sec. Reg. & L. Rep., March 3, 1982.

3. Issue: Asset management accounts for commercial banks ("sweep accounts")

Parties: VISA/Alliance Capital Management Group; Mastercard/Fidelity Mgnt. Res. Co.; various private label funds: Dreyfus, Lehman, Shearson

Status: SEC has indicated general disapproval; positions of Federal Reserve Board and Comptroller of Currency not known.

4. Issue: Mutual savings bank creation of money market fund

Parties: Boston Five Cents Savings Bank

Status: Various registration statements filed with SEC; also being considered by FDIC.

5. Issue: Clearing and executing agreements between banks and broker/dealers (creation of discount broker subsidiary)

Parties: Security Pacific National Bank/Fidelity Brokerage Services, Inc.

Status: Approved by Comptroller of Currency August 26, 1982, NOTE: Opinion of C of C suggests that previous "interpretations [by C of C] contained restrictions not imposed by the [Glass-Steagall Act] and accordingly were currently viewed to be erroneous" (Legal Times 9/6/82); Position of SEC not clear; some conflict appears between positions of NYSE and NASD, although future NASD membership anticipated.

6. Issue: Creation of savings and loan service corporation subsidiary to become fully registered broker-dealer

Parties: Savings Association Financial Corporation (SAFC); Savings Association Investment Services (SAIS), known as the "Invest" program

Status: Approved by FHLBB May 6, 1982; SEC issued No-action letter on July 8, 1982 stating that while participating S & L's would be deemed "associated persons" under §3(a)(18) of the 1934 Exchange Act, in view of full broker-dealer registration of SAIS including participating S & L personnel, no B/D registration of S & L's required.

7. Issue: Broad participation by subsidiaries or affiliates of commercial banks in securities activities

Status: FDIC Policy Statement, August, 1982 declared that Glass-Steagall Act does not prohibit state-chartered insured non-Fed member banks under FDIC supervision "from establishing an affiliate relationship with, or organizing or acquiring, a subsidiary corporation that engages in the business of issuing, underwriting, selling or distributing at wholesale or retail, or through syndicate participation - stocks, bonds, debentures, notes, or other securities."

B. Federal Legislative Developments Concerning Bank Securities Activities

The purpose of this outline is to give NASAA members a quick overview of recent federal legislative proposals rearding bank securities activities. For a more detailed look at the two most significant federal proposals - the "Administration" proposal and the Garn bill - and a thumbnail sketch of state concerns raised by both bills, members should take the time to read the memorandum attached as Appendix III.

1. The Treasury or "Administration" Proposal ("The Bank Holding Company Deregulation Act of 1982") S. 2490

Status: Not yet reported out of Senate Banking Committee.

Summary: Would permits banks to engage in securities activities through a bank securities affiliate. That affiliate would be considered either a broker ordealer within the meaning of the Investment Advisers Act of 1940. Would permit bank securities affiliates to conduct any securities activity which a bank may conduct; deal in and underwrite state and federal government general obligation bonds; organize, sponsor, operate, control or render investment advice to an investment company; and deal in and distribute commercial paper and other obligations of its bank holding company and obligations of other banks.

Would allow banks to continue to conduct common trust fund and collective investment fund activities without transferring them to an affiliate.

To some extent, would limit self-dealing and conflicts of interest by restricting tying arrangements, purchases of certain assets and advertising.

2. Senate Bill 1720 - The Garn Bill ("Financial" Institutions Restructuring and Services Act of

1981* Status: Securities title (Title V) withdrawn by Sen. Jake Garn (R-Utah). Title V does, however, stand a good chance of being reintroduced in next session of Congress.

Summary:

(a) Would amend Glass-Steagall Act to allow banks to deal in and underwrite non-general obligations issued or guaranteed by or on behalf of a state or any political subdivision of a state (except for special assessment obligations and industrial revenue bonds). Would impose limitations regarding: (i) amount; (ii) purchases from an underwriting syndicate in which the bank is participating; and (iii) purchases from the bank's own account as trader or dealer for its own investment account. Would require that sales of such obligations by the bank to its depositors or borrowers be accompanied by a written disclosure stating that the bank is selling as an underwriter or dealer.

(b) Would amend the Investment Company Act of 1940 to permit a bank, bank holding company or subsidiary thereof, a savings and loan association, a savings bank or a credit union to organize, sponsor, operate, control or render investment advice to an investment company; underwrite, distribute, sell or issue securities of any investment company if the officers and employees of the banks, savings and loan associations or credit unions who sell or issue such securities meet standards of training, experience and sales practice set by the agencies enforcing these provisions; and would exclude a savings and loan association, savings bank or credit union from the 1934 Act's definitions of "broker" and "dealer" even if it performs underwriting or dealing functions allowed by S. 1720.

3. S. 4040

Status: Introduced in the House in June, 1981 and referred to committee where it has received no action.

Summary: Would permit banks to underwrite all debt, including corporate debt.

4. H. R. 7014

Status: Referred jointly to the Committees on Banking, Finance and Urban Affairs and Energy and Commerce.

Summary: Would establish a Commission on Capital Markets to evaluate federal and state regulation of financial and investment institutions and other financial intermediaries. Such evaluation would evaluate the fairness of competition between such intermediaries and the impact of differences in regulation over intermediaries offering similar instruments and products.

III. MARKET DEVELOPMENTS IN THE BANK SECURITIES AREA

The term "market developments", as used in this report, includes the development of both new banking services and new banking products. The new services include principally the assumption by banks of traditional securities brokerage functions. That assumption is accomplished by either the acquisition of existing discount brokerage firms, as in BankAmerica's proposed acquisition of Charles Schwab and Co., or by arrangement for execution of securities transactions by an independent discount brokerage firm such as Fidelity Brokerage Service, Inc. New products include such investment vehicles as "sweep" accounts, in which excess demand deposits are automatically transferred into money market funds or retail repo agreements. Similarly, banks have requested permission to issue and offer mutual funds, pooled tax exempt lease obligations, and other investments opportunities not traditionally offered by banks. While a full description of these new products and services is beyond the scope of this report, a few words of explanation may prove helpful.

1. The Fidelity Brokerage Services, Inc. Agreements

Fidelity Brokerage Services, Inc. ("Fidelity"), an entity registered in 50 states, has proposed two types of agreements with banks. Each allows the bank to execute transactions through this broker-dealer. Fidelity representatives described for the Committee its arrangement with Security Pacific National Bank ("SP").

After SP failed to acquire Charles Schwab and Co., SP contracted with Fidelity to act as agent for its banking customers. In essence, the bank provides discount brokerage services by using Fidelity's electronic transmission system.

SP advertises brokerage services, not specific securities. An SP employee enters each order into Fidelity's data processing system, although the trades are actually executed by Fidelity, and each account is a Fidelity brokerage account. Fidelity has no direct contact with the customer in the initial sale. Confirmations, however, are mailed by Fidelity, and the account is held on a fully disclosed basis.

Fidelity offers no recommendations or financial advice and maintains that all orders are unsolicited. SP is compensated on the basis of the number of executed transactions. SP has the ability to enter option and margin transactions as well as normal securities transactions. This full service plan is in effect for two other banks as of September 10, 1982.

The limited-service plan does not allow the bank to enter orders into the Fidelity system. The bank is restricted to opening accounts for Fidelity. Unlike the full service plan, which requires the bank to offer brokerage services from one location and to hire experienced securities personnel, the limited-service plan allows branch office personnel to aid in the completion of applications and to discuss brokerage services. Approximately 45 banks have signed such limited service agreements. Under both plans, the bank is committed to providing brokerage services exclusively through Fidelity and all advertising must be approved by Fidelity.

When asked about the future of their brokerage agreements with banks, Fidelity representatives felt that their system could survive any attempt by banks to enter the brokerage business directly, since the high cost of developing the data processing system needed for execution of such a high volume of securities transactions would blunt the impact of such competition.

2. Sweep Accounts

Sweep accounts allow a bank customer to place excess funds into a money market fund or retail repurchase agreement, with the funds being automatically transferred from the depository account by the bank. Most sweep accounts thus represent a one-time investment decision, since the funds are transferred from the depository account without separate consultation with the depositor.

3. Pooled tax-exempt lease obligations

Under this scheme, the customer purchases public non-redeemable, pass-through certificates evidencing fractional undivided interests in a pool of tax-exempt lease obligations. The banks become involved by issuing an irrevocable letter of credit which supports the obligation. The issuers claim an exemption for registration, asserting that the bank letter of credit functions as a guarantee. The bank will collect a fee for "securing" the obligation. For purposes of these transactions, "securing" means collecting payments, billing, and record-keeping. These functions are traditional securities sales activities. For an example of one state's positions on bank letters of credit as "guarantee" see Maryland Securities Division letter of November 19, 1980 attached hereto as Appendix IV.

IV. CONCLUSIONS AND RECOMMENDATIONS FOR NASAA ACTION

This report could only outline the very basic elements of the existing federal and state regulatory structures, summarize the most important federal regulatory and legislative trends, and skim the surface of the current market developments.

Events in the area have moved so quickly that the NASAA membership has not had an opportunity to give reasonable consideration to the issues raised by the changing financial marketplace. The Committee initially considered the possibility of engaging the membership in a discussion of bank related issues at one of the business sessions in Seattle. However, the existing agenda for those meetings is already extensive, and the absence of sufficient background information would have severely inhibited the length and substance of the discussion.

In order to provide guidance to the membership and to the Committee, the Committee recommends that the membership endorse the funding of a two day meeting for the purpose of a full exploration of the issues raised by the entry of commercial banks and related institutions into the securities business. Upon request, NASAA would fund the attendance of one administrator or senior staff person at a forum on this subject. It is envisioned that the first day of the forum would be for presentations by banking and securities industry professionals, as well as state and federal regulators, intended to examine the current marketplace, regulatory matters and legislative developments.

The second day would be a closed NASAA session where we could discuss specific directions to be pursued by the membership and the Committee. It is anticipated that the first day of the forum would provide sufficient background and food for thought to enable the membership to formulate some ideas about future NASAA involvement and resource commitment in this area. Another benefit to be derived by this forum would be the considerable attention NASAA would receive by virtue of its willingness and desire to address a subject of such national concern.

Special mention of the following individuals should be made for their substantial efforts in the preparation of this Report:

Financial Institutions Committee:

Richard Slavin - Connecticut
Michael Unger - Massachusetts
Edwin Walker - Tennessee

Legislation Committee:

Cynthia Antanaitis - Connecticut
Robert Geake - West Virginia

Co-Reporters for Revision of the Uniform Securities Act:

Professor Joseph Long, University of Oklahoma
Professor Mark Sargent, University of Baltimore

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Massachusetts Securities Division
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July 6, 1982

Honorable John S. R. Shad
Chairman
Securities and Exchange Commission
500 North Capital Street, N.W.
Washington, D. C. 20549

Re: Savings Association Investment Securities, Inc. - Request for No Action

Dear Chairman Shad:

At a recent meeting of its Board of Directors, the North American Securities Administrators Association ("NASAA") created an ad hoc committee on Financial Institutions. The Committee's charges are:

1. to monitor current developments in Washington flowing from the Depository Institutions Deregulation Act, the various Administration and other Congressional initiatives regarding amendments to the Glass-Steagall Act and pending actions before various federal agencies impacting upon the structure of financial institutions and the evolution of new financial products and services;

2. to assess the impact of these developments upon state securities regulation; and

3. to advance recommendations to our membership as to appropriate statutory and administrative policy changes at the state level.

In view of the relative infancy of this committee, there has been no opportunity for polling our membership regarding the substance of this letter. Accordingly, any observations, conclusions or opinions stated herein are those only of the undersigned committee members and should not be considered as necessarily representative of the NASAA members.

Considering the novel factual situation presented by the Savings Association Investment Services, Inc. ("SAIS") request and the broader policy implications under both federal and state securities laws, the committee members feel compelled to communicate directly to the Commission their concerns. In addition, we take this opportunity to urge the Commission to give careful consideration, in both the present and any similar future deliberations, to the inevitable implications upon state securities regulation arising from the Commission's policy decisions, particularly as similar problems arise from the current Glass-Steagall Act developments. We also request that the Commission inform NASAA of similar future pending policy determinations impacting upon financial institutions and, to the extent possible, afford NASAA the opportunity to provide some insight to the Commission on the collateral impact upon state regulation.

Of particular concern to us are developments relating to the expansion of non-investment banking institutions into the area of broker/dealer activities. Presently, virtually every state has a broad exemption or exclusion from the definition of broker/dealer for banks, savings institutions and trust companies, similar to that exclusion found in Section 401 of the Uniform Securities Act. These definitional exclusions, as with their counterparts under the federal securities laws, are appropriate when it is considered that, at the time of their drafting, these provisions had to be read in the context of the limitations imposed by the Glass-Steagall Act. As a general rule, these exemptions have received relatively narrow construction as historically applied and, therefore, the exclusions do not extend to service corporations, bank holding companies and non-banking affiliates and subsidiaries. Direct investment banking activities by the core financial institution was prohibited by the Glass-Steagall Act and other statutory and regulatory prohibitions.

We understand that the Federal Home Loan Bank Board, on May 6, 1982, approved a proposal by several savings and loan associations to establish through their service corporations a new service corporation known as Savings Association Financial Corporation which will, in turn, form a wholly owned subsidiary ("SAIS") which intends to become a registered securities broker/dealer at both the federal and state level. The securities services of that broker/dealer will be available on the premises of savings and loan associations desiring to subscribe to the SAIS program. We also understand that the Federal Home Loan Bank Board's approval extends only to the propriety of this activity through the vehicle of a service corporation and does not extend to authorization for direct savings and loan participation in brokerage activities. Taken on its face, the proposal therefore does not suggest any immediate departure from the present scheme of federal and state registration of broker/dealers.

The particular, and somewhat unusual, facts of the SAIS proposal nevertheless present numerous items of concern. It is apparently these items which have given rise to the request for a "no action" determination by the Commission and the staff of the Division of Market Regulation as to the possible status of the core savings and loan associations as broker/dealers.

The aspects of the SAIS program which suggest broker/dealer implications for savings and loan associations are the provisions for location of the SAIS brokerage services on the premises of the savings and loan associations and the provision contemplating that the registered representatives of the broker/dealer will also be employees of the savings and loan associations, simultaneously performing non-securities duties. As a natural consequence of these structural arrangements, we note the following problems conveying policy implications:

1. The possibility for lack of adequate on-site supervision of registered representatives;

2. The possible conflicts of interest that may arise from serving two masters;

3. The possibility for improper tie-ins of securities sales to depository and loan approval services; and

4. The conceptual problem of whether the core savings and loans thereby become "person(s) associated with a broker or dealer" within the meaning of Section 3(a)(18) of the Securities Exchange Act of 1934.

We also note that the SAIS proposals for certain "exclusive" arrangements with mutual funds and clearing brokers, combined with the proposed utilization of uniform classes of recommendations convey possible policy implications with regard to full disclosure, "back office compliance" and investor suitability determinations. These features, combined with the announced intention to compensate securities representatives on a non-commissioned salary basis contribute to the novelty of the SAIS request.

Although not necessarily appropriate for consideration by the Commission, we are concerned with the possible implications arising under various state franchise laws from the sale of the SAIS brokerage services to subscribing savings and loan associations.

Although concerned about the supervision, tie-in and conflicts of interest problems, we offer the observation that these elements perhaps can be addressed most effectively only on an "after the fact" basis. Since it is contemplated that the states will have jurisdiction over SAIS as a registered broker/dealer, evidence of abuse in these areas should afford opportunity for state administrators to exercise their respective suspension and revocation powers.

Of perhaps the greatest potential impact upon state regulation would be the Commission's determination regarding the status of savings and loan associations as associated persons. Our Committee's initial concern was that a determination by the Commission that a subscribing savings and loan association was not an associated person could significantly inhibit subsequent enforcement action by state administrators in hypothetical situations where non-registered savings and loan personnel participated directly or indirectly in securities sales. For example, in the dual employment and on-premise structure proposed by SAIS, it is conceivable that a savings and loan manager who is not registered as a securities representative could exert substantial influence over the activities of, for instance, an assistant savings and loan manager who is also acting as the registered representative of SAIS.

On further analysis of the SAIS proposal, our Committee has concluded that regardless of the position adopted by the Commission regarding classification as associated persons, the jurisdiction of state securities administrators to regulate the securities activities of the core savings and loan associations may be unaffected. This perceived lack of Blue Sky effect results from the differing definitional approaches contained in the regulatory structures of the state and federal laws.

Under federal law, the concept of "person associated with a broker/dealer" is used as a control device to regulate the activities of those persons who, while not themselves registered as broker/dealers, are nevertheless involved directly or indirectly with securities transactions. At the state level (at least in those states which have adopted some form of the Uniform Securities Act), the control of these persons is maintained by the application of the concept of a broker/dealer's "agent." Section 401 of the Uniform Securities Act defines "agent" inter alia as "any individual other than a broker/dealer who represents a broker/dealer or issuer in effecting or attempting to effect purchases or sales of securities." Therefore, while a determination by the Commission that a savings and loan association is not an associated person for federal regulatory purposes may inhibit a state regulatory conclusion to the contrary, such determination should not operate to preclude state jurisdiction over savings and loan employees who engage in securities transactions on a non-registered basis.

We urge the Commission to carefully consider the broad policy implications suggested by the SAIS request, particularly when viewed as a precursor to probable similar requests by other financial institutions. With regard to the implications for state securities regulation presented by the SAIS program, and with the qualification that we are speaking only as Committee members and not on behalf of the NASAA membership, it is the unanimous conclusion of our Committee that there are no facts present in the SAIS request suggesting that a Commission decision to grant the no action request would be inconsistent with the public interest or with the basic scheme of state securities regulation.

Very truly yours,

K. Houston Matney
Maryland Securities Commissioner
Chairman, Ad Hoc Committee
on Financial Institutions

Thomas L. Krebs
Director
Alabama Securities Commission

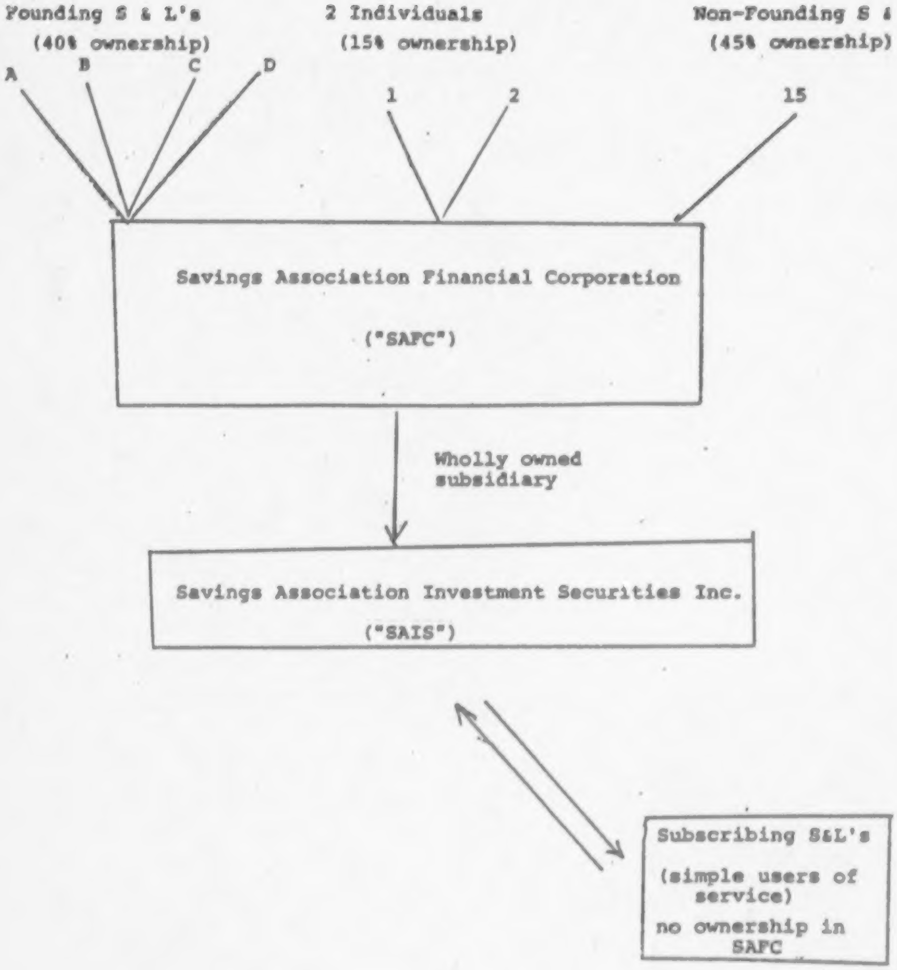
Joseph W. Schoeberl
Commissioner of Securities
State of Missouri

Richard Slavin
Director, Securities and
Business Investments Division
Connecticut Banking Department

Michael Unger
Director, Securities Division
of Commonwealth of Massachusetts

KHM/bhl/0178T

Organizational Structure of "SAFC" and "SAIS"


Founding S & L's
(40% ownership)
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2 Individuals
(15% ownership)
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Non-Founding S &
(45% ownership)
15
Savings Association Financial Corporation
("SAFC")
Wholly owned subsidiary
Savings Association Investment Securities Inc.
("SAIS")
Subscribing S&L's
(simple users of service)
no ownership in SAFC

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August 4, 1981

Joseph R. Crouse, Esquire
State Bank Commissioner
1301 Blaustein Building
One North Charles Street
Baltimore, Maryland 21201

Re: Bank Retail Repurchase Agreements

Dear Mr. Crouse:

You have requested the advice of the Division of Securities as to the applicability of the Maryland Securities Act, Md. Corp. & Ass'ns. Code Ann. §11-101 through §11-805 (1975) (the "Act") to "retail repurchase agreements" ("Repos") as described in Banking Circular BC-157 of the Comptroller of the Currency dated May 13, 1981 (the "Circular") and the accompanying OCC Staff Analysis of Certain Legal Issues Raised by Retail Repurchase Agreements (the "OCC Staff Analysis").

Although not expressly defined in the Comptroller of the Currency materials, the Division understands a Repo to be an agreement involving the sale by a bank of an uninsured interest in U.S. Government or agency securities in denominations of less than $100,000 for a term of less than 90 days, subject to an agreement by the bank to repurchase the interest.

As noted in the OCC Staff Analysis, the terms and conditions of individual Repos may vary. The most common characteristics are: "the 'sale' to the public of a small-denomination, undivided fractional interest in an underlying, larger face amount government security, subject to the bank's (i.e., the 'seller's') unconditional obligation to repurchase that interest within 89 days or less for a pre-determined amount, typically the sum of the original investment plus 'interest.' The OCC Staff Analysis notes that, under a Repo, the purchaser "...obtains only limited indicia of ownership with respect to the underlying government security."

The Staff Analysis further notes that "(i)n effecting such a transaction, the bank issues an 'evidence of indebtedness' ...whereby it unconditionally promises to pay a specified amount at a future date to the purchaser of the Repo."

Although noting that the precise status of Repo transactions under the securities laws has not been conclusively addressed, the OCC Staff suggests that the sale of participations in underlying government securities, coupled with the bank's repurchase obligation, may constitute "evidence of indebtedness" or "investment contracts" under applicable state and federal securities laws. Section 11-101(o) defines "security" to include *inter alia* "evidence of indebtedness" and "investment contract." Although a more precise classification of Repos within these categories would require factual analysis of specific agreements, the Division concurs with the OCC Staff Analysis and concludes that agreements possessing the characteristics described above would satisfy the statutory definition of "security" as employed in the Maryland Act.

Section 11-601(3) of the Act provides an exemption from the registration requirements of the Act (but not from the anti-fraud and civil liability provisions) for:

> "Any security issued by and representing an interest in or a debt of, or guaranteed by, any bank organized under the laws of the United States or any bank, savings institution, or trust company organized and supervised under the laws of any state;"

The Division concludes, therefore, that commercial banks supervised by the Office of the Maryland Bank Commissioner and national banks subject to supervision by the Comptroller of the Currency may offer and sell Repos in the State of Maryland without compliance with the registration and prospectus requirements of the Act. It should be noted that this exemption extends only to issuing banks and is not available to bank holding companies or to non-banking affiliates or subsidiaries.

As discussed in the Circular and the OCC Staff Analysis, banks contemplating the issuance of Repos should nevertheless consider the full disclosure requirements of the securities laws and undertake to provide appropriate disclosure to prospective Repo purchasers. Banks contemplating the issuance of Repos should carefully consider the adequacy of the disclosure requirements necessary in order to enable a prospective investor to make an informed investment decision. The Division recommends that the disclosure guidelines contained in the Comptroller's Circular (pages 3 and 4) (a copy of which is attached hereto) should be considered as de minimus and that any offering materials be accompanied by a copy of the bank's most recent certified financial statements. In addition, it is recommended that such offering materials include the following legend in bold type:

> THESE SECURITIES ARE OFFERED FOR SALE IN THE STATE OF MARYLAND PURSUANT TO AN EXEMPTION FROM REGISTRATION WITH THE DIVISION OF SECURITIES OF THE DEPARTMENT OF LAW OF MARYLAND. NEITHER THE DIVISION OF SECURITIES NOR THE MARYLAND BANK COMMISSIONER HAS PASSED IN ANY WAY UPON THE MERITS OF, RECOMMENDED, OR GIVEN APPROVAL TO THESE SECURITIES. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

In addition, it is suggested that a similar bold type legend be included warning the purchaser that the Repo is not a deposit and is not insured by the FDIC or other similar agency.

Although designed for conventional securities in the form of stocks, additional guidance as to the adequacy of disclosure may be found in Division Rule 2.02.03.01 (COMAR) and in the Comptroller of the Currency Securities Offering Disclosure Rules (12 CFR 16).

For your additional information, the Maryland Securities Act, Section 11-101 excludes from the definitions of "agent" and "broker-dealer" banks and persons effecting transactions in securities exempted by inter alia Section 11-601(3).

The advice contained in this letter relates only to the Division's position with regard to the applicability of the Maryland securities law to Repos. To the best of our knowledge, the Securities and Exchange Commission has taken no formal position with regard to the applicability of the various federal securities laws to these transactions. In this regard, it is suggested that state banks give full consideration to possible compliance problems under the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940. In addition, the offer and sale of Repos by Maryland banks to non-Maryland residents may also raise compliance problems with the state securities laws of other jurisdictions.

Sincerely,

K. Houston Matney

KHM/bhl

Enclosure

MEMORANDUM

TO K. Houston Matney
Chairman, Legislation Committee
North American Securities
Administrators Association, Inc.

FROM: Cynthia E. Antenaitis
Robert W. Geske

SUBJECT: Updated Overview of Federal Legislative Proposals
Concerning Bank Securities Activities

DATE: September 10, 1982

I Background

Commercial banking was severed from investment banking in the era of massive bank failures which became known as the Great Depression. Enacted in 1933, the Glass-Steagall Act created this formal separation by prohibiting commercial banks from affiliating with any organization "engaged principally in the issuance, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities...." 12 U.S.C. §377 (1976). The Act also barred national banks from (1) purchasing or selling securities except securities purchased or sold for the account of customers and (2) underwriting any issue of securities or stock.

Glass-Steagall, however, did not preclude banks from engaging in all securities-related activities. Despite the Act's restrictions, a bank could: (1) perform brokerage services for the account of, and on the order of, customers (2) purchase corporate bonds, debentures and other debt securities for its own account, subject to regulations prescribed by the Comptroller of the Currency and (3) underwrite and market general obligation bonds of the United States and of State and local governments. Banks were and continue to be active in securities markets through their trust departments, their involvement encompassing pension fund management and other collective investment fund activities.

Today, with large commercial banks and equally large investment companies competing furiously for investment dollars, Congress has been confronted with two proposals that would alter Glass-Steagall and the present structure of capital markets. The securities provisions of both bills contain controversial elements and, primarily for that reason, neither proposal should make headway in Congress this year. Indeed, Title V of the "Depository Institutions Amendments of 1982" has been withdrawn by Senator Jake Garn, its sponsor and staunchest supporter. Title V would have granted depository institutions the authority to offer mutual funds and money market funds and underwrite municipal revenue bonds. Passage of the Administration proposal (S. 2490) ([redacted]) is doubtful since the bill most likely will not be reported out of the Senate Banking Committee this session. The securities provisions of each bill, however, merit careful examination since 1) each proposal is a barometer of deregulatory changes affecting the banking and securities industries 2) both bills represent a legislative reaction to industry pressure to alter the existing competitive structure and 3) both proposals may foreshadow the direction states should follow in responding to the breakdown of some very basic assumptions underlying their securities laws. This memorandum will therefore discuss both proposals in detail. The questions each bill raises will undoubtedly surface again and

and again - and states would do well to confront the issues in a straightforward and thoughtful manner.

II The Treasury or "Administration" Proposal ("The Bank Holding Company Deregulation Act of 1982") S. 2490

The Treasury Bill would amend several pieces of legislation - the Glass-Steagall Act, the Securities Exchange Act of 1934, the Bank Holding Company Act of 1956, the Federal Reserve Act, the Federal Deposit Insurance Act and the Investment Company Act of 1940 - to prime its approach to facilitating bank entry into the securities area.

Subject to various safeguards contained in the bill, banks would be permitted to perform various securities activities. The bill provides that an "eligible association" (as defined in Section 2 of the bill) or a bank holding company may establish or acquire a bank securities affiliate. A bank securities affiliate, as defined in Section 7 of the bill, is a corporation that engages in one or more of the securities activities delineated in Section 10, and is a broker or dealer within the meaning of the Securities Exchange Act of 1934 or an investment adviser within the meaning of the Investment Advisers Act of 1940. The securities affiliate must be owned or controlled by a bank holding company or an eligible bank as defined in Section 16 of the Glass-Steagall Act. Section 2 specifically kallows a member bank to be affiliated with a bank securities affiliate.

The bill further provides that essentially all of the securities activities it permits, and most of the securities activities that banks are presently allowed to conduct, must be performed only by the bank securities affiliate.

Section 3 requires any eligible association establishing or acquiring a bank securities affiliate to transfer to the affiliate, no later than one year after the affiliate has commenced business, activities concerning 1) the dealing in and underwriting of obligations of the United States 2) state, local or U.S. general obligation bonds and 3) securities brokerage activities (i.e. activities that a bank may perform pursuant to Glass-Steagall). Section 10 requires any bank subsidiary of a bank holding company that establishes or acquires a bank securities affiliate to transfer to the affiliate the same activities mentioned above. This transfer of activities need not take plase until the expiration of one year from the date when the bank securities affiliate begins offering services authorized by the bill. The Federal Reserve is to prescribe rules and regulations determining those securities activities and securities-related activities in which banks affiliated with securities affiliates and eligible associations shall not engage.

Section 10 sets forth the securities activities which bank securities affiliates have the power to undertake. Bank securities affiliates would be allowed to: (1) conduct any securities or securities-related activity which a bank is not prohibited from conducting (2) deal in an underwrite all obligations issued or guaranteed by or on behalf of a state or any political subdivision of a state or any agency or instrumentality of either of the foregoing (except industrial development bonds) (3) organize, sponsor, operate, control or render investment advice to an investment company, as defined in Section 3 of the Investment Company Act of 1940 and (4) deal in and distribute commercial paper and other obligations of its affiliated bank holding company and any subsidiaries thereof, and deal in and distribute certificates of deposit, bankers' acceptances and other obligations of any bank, including bank subsidiaries of its affiliated bank holding company. In particular, banks affiliated with a securities affiliate and eligible association may not perform the activities described in (2), (3) and (4) above after one year from the date on which any such bank securities affiliate first engages in any of these activities. Those activities may be performed only by the securities affiliate.

Significantly, the above activities which a bank securities affiliate may conduct are in addition to the presently authorized bank securities activities which must be transferred to the bank securities affiliate after one year, as previously noted in this analysis. It is also important to note that, other than those securities activities which the bill directs a bank to transfer, a bank affiliated with a bank securities affiliate is not prohibited from performing other securities or securities-related activities. This part of the bill makes it appear that banks may thus continue to conduct their common trust fund and collective investment fund activities through their trust departments. In addition, bank regulatory agencies would retain enforcement authority over (1) bank securities activities prior to the mandatory transfer of certain securities activities to the bank securities affiliate (2) bank securities activities that are not transferred to the securities affiliate within the one-year transitional period and (3) the securities activities of banks that do not establish or become affiliated with a bank securities affiliate.

The bill contains provisions designed to limit self-dealing and conflicts of interest. Section 14 restricts transactions between a bank and its affiliates. This provision mandates that covered transactions and financial assistance transactions between member banks and their subsidiaries with affiliates must be made on substantially the same terms as comparable transactions with non-affiliated companies. The provision also (1) limits the amount of financial transactions between banks and affiliates (2) prohibits purchases of low quality assets from affiliates (3) prohibits member bank purchases, as fiduciary, of affiliate securities or assets unless lawfully authorized (4) prohibits any advertising indicating that a member bank shall in any way be responsible for the obligations of its affiliates and (5) prohibits member banks and their subsidiaries from knowingly purchasing or acquiring, during the existence of any underwriting or selling syndicate, any obligation the principal underwriter of which is an officer, director, member of any advisory board, or employee of such member bank or subsidiary. The terms "affiliate", "financial transaction", "covered transaction", and "low-quality asset" are defined in this section. The section also contains exemptions from its restrictions for certain transactions.

Section 16 of the bill would amend the Investment Company Act of 1940 to prohibit an investment company affiliated with a bank securities affiliate from: (1) placing or maintaining its securities or similar investments in the custody of a bank affiliated with such bank securities affiliate (2) designating any such bank as trustee or custodian or (3) depositing designated proceeds with any such bank. Section 17 would prohibit any subsidiary of a bank holding company from using tying arrangements in providing services.

Other sections of the bill would expand the activities in which a bank holding company may engage. Section 9 would add a new exemption to the general prohibition against nonbanking activities to expressly permit a bank holding company to engage in activities of a financial nature. The Federal Reserve Board is to promulgate regulations defining which activities are of a financial nature. Certain activities are listed in this section to be specifically considered within the meaning of the terms, such as operating an industrial bank, Morris Plan Bank or industrial loan company as authorized under State law, or leasing personal or real property. The Federal Reserve Board is directed to give primary consideration to public benefits that would result from increased competition between bank holding companies and other firms offering services of a financial nature. Section 11 would permit bank holding companies to engage in insurance underwriting and brokerage, and Section 12 would permit such companies to engage in real estate investment, development, or brokerage. Neither section requires any prior approval from or notice to the Federal Reserve before such activities may be conducted.

Sections 4 and 6 cover the ability of banks to have directors, officers, or employees of member banks simultaneously serve in those capacities with a bank securities affiliate, and the composition of the Municipal Securities Rulemaking Board.

III Senate Bill 1720 - The Garn Bill ("Financial Institutions Restructuring and Services Act of 1981")

The Glass-Steagall amendments contained in S.1720 are set out in Title V of this massive piece of legislation which originally sought to affect numerous areas of banking and savings institutions law. S.1720 would have pursued a different route than the Treasury Bill in allowing banking institutions to enter the securities field.

S.1720 would not require that a bank securities affiliate be established to conduct sanctioned securities activities. The bill would have amended the Glass-Steagall Act by allowing banks to deal in and underwrite nongeneral obligations issued or guaranteed by or on behalf of a State or any political subdivision of a State (except special assessment obligations and industrial revenue bonds), subject to limitations concerning amount, purchases from an underwriting syndicate in which the bank is participating, and purchases from the bank's own account as trader or dealer for its own investment account. Sales of such obligations by the bank to its depositors or borrowers would have had to be accompanied by a written disclosure stating that the bank was selling as an underwriter or a dealer. This section of the bill also would have directed the Secretary of the Treasury to submit an annual report to Congress showing the extent of commercial bank dealing in these obligations as compared with other banking institutions to determine the effect of this amendment on the institutional distribution of the business.

S.1720 also would have amended the Investment Company Act of 1940 to allow a bank, bank holding company or subsidiary thereof, a savings and loan association, a savings bank or a credit union (notwithstanding the limitations of the Glass-Steagall Act, the Federal Reserve Act and the Bank Holding Company Act) to: (1) organize, sponsor, operate, control, or render investment advice to an investment company or (2) underwrite, distribute, sell, or issue securities of any investment company if the officers and employees of the banks, savings and loan associations or credit unions who sell or issue such securities meet standards of training, experience, and sales practices which the agencies enforcing these provisions will determine, and, in consultation with the Federal Financial Institutions Examination Council, prescribe by regulation. Compliance with the standards would involve several different agencies such as the Comptroller of the Currency for national banks, the Federal Reserve's Board of Governors for Federal Reserve member banks, the Federal Deposit Insurance Corporation for banks and savings banks insured by the F.D.I.C. (other than members of the Federal Reserve System), the Federal Home Loan Bank Board and the National Credit Union Administration Board. The Securities and Exchange Commission would have enforced the standards except to the extent that their enforcement would have been specifically committed to one of the aforementioned agencies. This proviso would appear to have left the SEC with very little to enforce in the way of the standards.

S.1720 would have further provided that a savings and loan association, savings bank or credit union would not be deemed a "broker" or "dealer," as defined in the Securities Exchange Act of 1934, because it engages in any of the functions of underwriting or dealing allowed by the bill. The terms "bank holding company" and "subsidiary" with respect to a bank holding company were to have had the meanings provided for by Section 2 of the Bank Holding Company Act of 1956.

IV State Concerns Raised by Both Bills

One of the purposes of the Glass-Steagall Act was to foster public confidence in financial institutions by controlling the financial risks which those institutions could take. Another purpose was to afford such institutions preferred status. The limitation of financial risks and the grant of preferred status were inextricably linked together to preserve public confidence in the nation's economic system.

That was in the depression era. Today, however, more and more financial institutions are fighting to stay alive competitively and they are willing to take more risks to do so. It is their own stability rather than the stability of the economic system generally that has assumed importance. With the erosion of the Glass-Steagall Act, a serious question has arisen whether financial institutions should still be entitled to competitive advantage. Assuming that the states are not willing to allow financial institutions to slip into the securities area unnoticed, any regulatory changes which the states might implement to oversee the securities activities of financial institutions may sharply affect the preferred status of those institutions. This is a tremendous policy decision for states to make.

The Administration Bill appears to take the most reasonable approach to amending Glass-Steagall. By mandating the separation of certain securities activities in a securities affiliate instead of a bank, and by providing that a securities affiliate will be an investment adviser or a broker-dealer under federal securities statutes, the bill does some ground-breaking for the states by attempting to place securities affiliates on a regulatory par with "traditional" broker-dealers and investment advisers. States whose laws now specifically exclude banks and savings institutions from the definition of "broker-dealer" and "investment adviser" may, by interpretation, be able to establish jurisdiction over a bank securities affiliate and its activities. Ostensibly, a bank securities affiliate would not be considered a "bank" for purposes of the definition. States, however, would be forced to grapple with the question of how to define a "bank". This could become a particularly complex issue if the term "bank" is not defined in either the state's banking or securities laws. Whether or not the term "bank" should be limited to institutions taking deposits and whether it should have a specific definition solely for securities law purposes are points to consider.

Even under the Administration Bill, however, banks will remain able to carry on certain securities activities which need not be transferred to a securities affiliate. This factor, added to the bill's failure to require separate facilities for securities affiliates or to require dissimilar names and what some experts believe to be less than adequate bans on self-dealing and tying arrangements, raises concerns as to whether a bank's "securities" activities will be truly separate in the manner the bill suggests. States wishing to regulate such activities would thus be forced into the awkward position of scrutinizing each entity's organizational structure and risking ad hoc inconsistent determinations. Some commentators, in hearings before the Garn Committee, noted that separation of the activities of commercial banks and Real Estate Investment Trusts in the 1970s did not prevent certain self-dealing, conflicts of interest, investor confusion/loss of confidence and adverse effects on bank soundness - all of which the Glass-Steagall Act was designed to correct. While it would be unrealistic to assume that states could prevent a loss of public confidence in financial institutions, it may be possible for states to address some of the ethical problems which arise through their power to regulate broker-dealers and investment advisers.

Even with its problems, the Administration Bill is vastly preferable to S. 1720. It appears that S. 1720 would allow banks to begin performing securities activities absent many of the safeguards or controls which apply to other large investment companies with whom they will compete. The bill specifically excludes savings and loan institutions, savings banks, and credit unions from the definition of "broker-dealer" contained in the Securities Exchange Act of 1934. Although banks are not so excluded, states which have exclusions for banks, as well as savings institutions, contained in their laws will face obvious difficulty in establishing regulatory authority over banks and other financial institutions covered by the bill even though such institutions will be performing activities similar to those performed by "traditional" broker-dealers and investment advisers. Unless they decide to do nothing, states will be compelled to make some changes in their laws, either by way of statutory amendment or by interpretation of existing provisions. Any interpretation which would attempt to increase regulatory authority over banking institutions would probably be strenuously opposed by those institutions. In addition, interpretation would have to be based on a functional analysis of banking operations, an approach that may vary from state to state and which could create some uncertainty in the financial community. Moreover, any state approach which is divergent from that taken by federal regulatory authorities would shatter the trend toward federal-state cooperation in the area of securities regulation which has been evolving in recent years. Any over-regulatory policy adopted by the states would also contravene the deregulatory position taken by the current Administration.

Senate Bill 1720 fails miserably to adequately deal with the problems of self-dealing, conflicts of interest and related potential abuses. The bill would appear to allow bank securities activities to be carried on at the same time, through the same facilities and with the same employees as bank depository functions. By providing that "standards of training, experience and sales practice" must be established by a myriad of bank regulatory agencies instead of by the Securities and Exchange Commission, the bill may ultimately allow persons who have little or no qualifications in the securities field to deal directly with the public. In the event of a complaint, disgruntled investors would have to face a hodge-podge of agencies which are inexperienced in securities. The states would likewise be inexperienced (unless the same agency regulates both banking and securities activities) since banks and other financial institutions have traditionally been excluded from the scope of broker-dealer and investment adviser regulation. In dealing with potential ethical problems, states would have to set up standards regulating the conduct of financial institutions acting as broker-dealers or investment advisers. Whether those standards should be precisely the same as the standards imposed on "traditional" broker-dealers and investment advisers or whether a separate set of standards should be imposed on financial institutions depends on whether (1) states wish to place financial institutions on a par with "traditional" broker-dealers and investment advisers and (2) whether specific standards must be tailored to accommodate bank securities activities. There is a question, for example, whether the same testing requirements should be imposed on financial institutions as on "traditional" broker-dealers. If any massive restructuring has to be done, all agencies involved must be up to the task.

Of course, any state which has adopted the Uniform Securities Act (the "USA") could always attempt to regulate bank securities activities under the general anti-fraud provisions of the USA. Those provisions address the misconduct of any "person" rather than the misconduct of a particular class of persons. Reliance on the anti-fraud provisions, however, may be inadequate since (1) those provisions do not provide a comprehensive and responsive regulatory framework and (2) fraud may be difficult to prove. Consequently, reliance on statutory anti-fraud provisions should be viewed as a state strategy of last resort.

V Conclusion

Both the Administration proposal and the Garn bill represent an attempt to legislatively respond to a clear deregulatory trend. That the Glass-Steagull Act is being eroded is beyond dispute. The Administration proposal is more palatable than the Garn bill since it concentrates less on securities activities conducted by banks and more on securities activities conducted by securities affiliates. The distinction is artificial, to be sure, and may not adequately deal with potential ethical problems. The real difference between the two proposals, however, is the speed with which change is to be effectuated. The undertaking suggested by the Administration proposal is more modest than that suggested by the Garn bill. In the long run, however, the same objectives may well be achieved. With the failure of Congress to take a definitive stance on the issues this year, the door has opened to myriad administrative approaches which may be subject to challenge. For example, the FDIC has already ruled that nonmember state banks may engage in securities related activities through securities subsidiaries.

It would thus be wise for the states to continue to closely monitor regulatory developments in this fast developing area. Despite the lag in Congressional action, time remains at a premium. Whatever position the states ultimately adopt, that position should be firmly rooted in a sensible policy approach which considers all pertinent factors and which is not merely a knee-jerk reaction to changes in the economic and regulatory climate.

STEPHEN H. SACHS
ATTORNEY GENERAL

GEORGE A. NILSON
DEPUTY ATTORNEY GENERAL

R. HOUSTON MATNEY
SECURITIES COMMISSIONER

THE ATTORNEY GENERAL
DIVISION OF SECURITIES
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November 19, 1980

The Honorable Stephen H. Sachs
Attorney General of Maryland
One South Calvert Street
Baltimore, Maryland 21202

Re: "CHOICE" Card

Dear Mr. Sachs:

On October 3, 1980 you requested the Division of Securities to undertake a review of certain features of the "Choice Card" presently being offered to Maryland residents by Citicorp Financial, Inc. ("CFI") to determine if these features constitute the offer or sale of a security and, if so, whether the same is exempt from the registration requirements of the Maryland Securities Act.

Subsequent to your request, the Division has engaged in numerous communications with CFI through its counsel, Messrs. Melnicove, Kaufman & Weiner, P.A. and Messrs. Shearman & Sterling. CFI has cooperated fully with the Division's request for production of documents and sales and advertising literature. In addition, counsel for CFI have provided the Division with opinions of counsel as to certain legal questions raised in our letter to Franklin Goldstein, Esquire of October 9, 1980. It should be noted, however, that CFI at no time has formally requested any interpretive opinion from the Division as to the applicability of the Maryland Securities Act to the Choice Card.

The Choice Card contains two features suggesting the presence of a security. The first is in the form of a contractual commitment by CFI to pay 5-1/2% interest on "credit balances". The second, and most significant feature, is the Purchase Plus Plan feature whereby CFI will pay 8% interest on funds deposited into a cardholder's account, which account is separate and distinct from the credit account. The funds may be automatically transferred to the CHOICE credit account if requested by the cardholder. The minimum amount needed to open the Purchase Plus Account is $25.00 and there is no limit on the amount which can be placed in the account. Amounts placed in the Purchase Plus Plan have no effect on the cardholder's credit limits and the only relationship to the CHOICE account is as a convenient vehicle for immediate transfer of a cardholder's interest bearing funds towards a reduction of outstanding obligations under the CHOICE account. We have been advised by counsel for CFI that funds deposited in the Purchase Plus account will not be segregated into individual bank accounts but rather will be commingled with deposits from other Purchase Plus depositors and used as general operating funds by CFI.

After an extensive review of this matter, and in the absence of any persuasive authority to the contrary, the Division has determined that the above mentioned features do constitute a "security" as defined in Section 11-101 (o) of the Maryland Securities Act including, without limitation, "evidence of indebtedness", "certificate of interest or participation in any profit-sharing agreement", and "investment contract".

Having determined that the above mentioned features of the CHOICE Card do come within the jurisdiction of the Maryland Securities Act, the Division then addressed the question as to whether an exemption from the registration requirements of the Act was available in either or both instances.

Section 11-601 (3) of the Act provides an exemption from the registration requirements of the Act (but not from the anti-fraud and civil liability provisions) for:

> "Any security issued by and representing an interest in or a debt of, or guaranteed by, any bank organized under the laws of the United States or any bank, savings institution, or trust company organized

> and supervised under the laws of any state;"

Since CFI would be the "issuer" of the above mentioned securities, no exemption from registration under Section 11-601 (3) or under any other provision of the Act would be available inasmuch as CFI is not itself a bank. CFI has advised the Division, however, that with regard to the Purchase Plus Plan feature, it is relying upon the Section 11-601 (3) exemption in that any security is "guaranteed" by a bank organized under the laws of the United States within the meaning of the exemption.

Specifically, all cardholders indicating an interest in utilizing the Purchase Plus Plan feature will be told that all monies deposited together with interest thereon will be guaranteed as to payment by Citibank, N.A. Upon the Division's inquiry, it was explained that this "guarantee" would be in the form of an Irrevocable Letter of Credit (the "Letter of Credit") issued by Citibank, N.A. to CFI "for the benefit of each of those individuals who open and maintain a CHOICE Purchase Plus Plan with CFI." The Letter of Credit (a copy of which is attached hereto as Exhibit 1) is dated October 1, 1980 and states that it will expire on September 30, 1981. A review of the Letter of Credit indicates that the obligation of Citibank thereunder is limited to an aggregate amount not exceeding $25,000,000.00.

Although counsel for CFI proffered authority to the Division to support its assertion that "it would appear that a Letter of Credit ought to be considered a 'guarantee' for purposes of Maryland law" the Division was not persuaded that the Letter of Credit in its original form was the functional equivalent of a "guarantee" within the meaning of Section 11-601 (3) of the Act. The Division concluded that inasmuch as the Letter of Credit was limited to a one year term and was additionally limited to a specific dollar amount that the likelihood existed for Purchase Plus deposits to exceed that amount or for any sums on deposit as of September 30, 1981 to lose the protection of the "guarantee".

The Division reviewed numerous "no action" letters issued by the Securities and Exchange Commission which letters, in effect, recognized letters of credit as "guarantees" for purposes of a comparable exemption under federal law. The Division does not find those letters determinative of the question inasmuch as they were issued with regard to the particular facts of the specific transactions which were the subjects of the letters. In addition, in each of those cases, the bank's obligation under the letter of credit fully covered the underlying obligation both in term and amount and, accordingly, did not address the potential Choice situation whereby the underlying obligation of CFI to cardholders might lose the availability of the "guarantee" because of the expiration of the letter of credit or because the deposit exceeded the amount covered by the letter of credit.

The Division communicated its concern in this regard to counsel for CFI who responded by advising the Division that the Letter of Credit would be revised to provide for automatic renewal upon its expiration unless 30 days prior written notice is given to all Participants. Copies of the revised Letter of Credit are to be provided to all Purchase Plus Plan participants (see Exhibit No. 2). In addition, we have been provided with a summary of existing internal controls intended to be utilized by CFI so as to insure that a daily review of all Purchase Plus Plan deposits are made by appropriate CFI officials so as to insure that daily deposits do not exceed the ceiling imposed under the Letter of Credit.

Although the Division is not persuaded that these arrangements are the functional equivalent of a "guarantee" within the meaning of the Act so as to support a full legal determination on that point, the Division nevertheless is satisfied that the pre-existing internal controls combined with the use of a revised Letter of Credit eliminate the need for compliance with the registration requirements of the Act. Accordingly, the Division proposes to take no enforcement action to require registration of the Purchase Plus Plan feature.

Although no specific exemption is available under the Act for the 5-1/2% feature, based upon our review of all advertising materials and upon the representations by CFI that the same will constitute only an incidental feature and that the same will be offered inconspicuously in promotional materials, the Division proposes to take no enforcement action to require registration with regard to this feature.

Although the Division raised other questions with regard to the applicability of both state and federal securities laws, we have received opinions of counsel satisfactory to the Division based on circumstances and marketing practices presently being employed.

It should be noted that our conclusions are based upon existing facts as known to us in this particular matter. We have specifically relied upon the revisions to the Letter of Credit and representations as to the existence of internal controls designed to insure that aggregate daily Purchase Plus deposits and CFI's obligations to Participants do not exceed amounts covered by the Letter of Credit or any subsequent or additional letters of credit. Should there be any change in any of the facts, marketing practices, terms of the Letter of Credit or internal controls, the Division's position may be subject to re-evaluation.

Sincerely,

K. Houston Matney

k, N.A
ll Street
ork, N.Y

Citicorp Financial, Inc.
7720 York Road
Towson, Maryland 21204 D/B/A "CHOICE"

October 1, 1980
MAIL
REF. 00440671

Dear Sirs:

We hereby open our Irrevocable Letter of Credit No. CCD-6-359-440671 in your favor for the benefit of each of those individuals who open and maintain a CHOICE Purchase Plus Plan with CFI (such individuals are hereinafter referred to as "CHOICE Participants").

This Letter of Credit is effective immediately and expires at our 111 Wall Street, New York, NY office with close of business on September 30, 1981.

We hereby undertake that CHOICE Participants may demand payment hereunder up to an aggregate amount of up to $25,000,000.00 (Twenty Five Million US Dollars) including accrued interest by presenting on or before September 30, 1981 at our office at 111 Wall Street, New York, NY the following two documents:

1) A signed written statement dated on or before presentment to us stating as follows:
   a) I am either a CHOICE Participant or the authorized representative of such CHOICE Participant,
   b) I have made demand on CFI for the amount of $ from my Purchase Plus Plan, but it has not been paid to me, and,
   c) The amount demanded is owed to me by CFI.
2) A copy of the last CHOICE monthly statement received before making this request showing at least the amount stated as due to the CHOICE Participant from his Purchase Plus Plan and demanded above.

Except so far as otherwise expressly stated, this credit is subject to the "Uniform Customs and Practices for Documentary Credits" (1974 Revision), International Chamber of Commerce (Publication 290).

Should you have occasion to communicate with us regarding this credit, kindly address all correspondence to our Letter of Credit Operations, North American Banking Group, 111 Wall Street, Third Floor, New York, NY 10043, making specific mention of our Credit No. CCD-6-359-440671.

Yours very truly,
WILLIAM I [illegible]
[illegible] LETTER [illegible]
Authorized Signature

October 29, 1980

Franklin Goldstein, Esq.

Franklin Goldstein, Esq.
Melnicove, Kaufman & Weiner
36 South Charles Street, 6th Floor
Baltimore, Maryland 21201

Re: Citicorp Financial, Inc. -"CHOICE"

Dear Frank:

In accordance with the meeting held with Commissioner Matney last Thursday, October 23, we are prepared to revise the Letter of Credit dated October 1, 1980 issued by Citibank, N.A. for the benefit of those "Choice" cardholders who open and maintain a "Choice" Purchase Plus Plan with Citicorp Financial, Inc. The revision would be to add a disclosure at the end of the second paragraph of the Letter of Credit, so that such paragraph would read in full as follows (new language underlined):

> "This Letter of Credit is effective immediately and expires at our 111 Wall Street, New York, N.Y. office with close of business on September 30, 1981, subject to annual automatic renewal unless 30 days prior written notice has been given by CPI to all Choice Participants."

We will proceed to incorporate this change and mail a revised Letter of Credit dated October 1, 1980 to all "Choice" cardholders who have established Purchase Plus Plans with CPI.

Very truly yours,

cc: John T. Schmidt, Esq.

Via Telecopier

North American Securities Administrators Association, Inc.

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March 8, 1983

Task Group on Regulation
 of Financial Services
Room 1060, Department of the Treasury
15th Street and Pennsylvania Ave., N.W.
Washington, D. C. 20220

Attention: Mr. Richard C. Breeden
Deputy Counsel to the Vice President

Gentlemen:

In a Notice from the Office of the Vice President, dated February 3, 1983 (the "Notice"), the Task Group on Regulation of Financial Services (the "Task Group") requested comments on a series of problems, issues, and options of the financial regulatory agency structure. This letter is being submitted in response to the Task Group's request by the North American Securities Administrators Association, Inc. ("NASAA"). NASAA is an association of state and provincial securities administrators from the United States, Canada and Mexico which, since 1918, has worked for investor protection. State securities commissioners are charged with promoting investor protection and regulating the securities markets in their respective jurisdictions. NASAA's activities involve cooperative efforts among its membership as well as with other law enforcement officials and certain federal agencies.

Since the spring of 1982, NASAA's Committee on Financial Institutions and its Legislation Committee have been closely monitoring the current reorganization of financial institutions for the purposes of: (i) formulating NASAA policy with respect to these developments; (ii) keeping NASAA's membership informed of important new developments; and (iii) maintaining a liaison with federal and other state agencies whose responsibilities in this area may overlap with those of our members. In addition to preparing an extensive committee report on these matters (see Attachment 1, the

"Committee Report"), these committees sponsored a "Financial Institutions Forum" on January 24-25, 1983 in Baltimore. The Forum brought together NASAA members, industry representatives, and spokesmen for the Securities and Exchange Commission, the Department of the Treasury, and the Banking, Housing and Urban Affairs Committee of the United States Senate. NASAA is thus vitally concerned with the issues now being considered by the Task Group.

In the Notice, the Task Group set forth an outline of problems, issues and options for consideration by the respondents (the "Outline"). This letter will first address certain portions of the Outline and then will provide a more general statement of concerns which the Task Group may wish to consider.

I. Goals of Financial Regulation

Part I of the Outline identifies four goals underlying the regulation of the financial markets:

1. Assuring safety and soundness of financial institutions, and of the financial system as a whole, both to protect individual depositors and to avoid or limit secondary effects of a failed institution.
2. Avoiding conflicts of interest, fraud, and consumer abuses.
3. Promoting orderly markets to encourage savings and capital formation and to support macro-economic stability.
4. Avoiding excessive concentrations of economic and financial resources.

After identifying these goals, the Notice asked whether they should "be reappraised in light of emerging realities in the marketplace."

NASAA recognizes that the goals of assuring the safety and soundness of financial institutions, supporting macro-economic stability, and avoiding excessive concentrations of economic and financial resources are primarily the responsibility of state and federal agencies other than the state securities administrations. We would emphasize, however, that the state securities administrators have, for more than seventy years, played a major role in maintaining the integrity of the capital markets by controlling conflicts of interest, fraud, and consumer abuse.

The close proximity of our member agencies to the investing public has enabled them to play that role not only with respect to "exotic" securities, commodity scams, and fraudulent business opportunities, but also with respect to the vast range of securities transactions which the Securities and Exchange Commission (the "SEC") does not have the opportunity to review in any detailed manner. In addition, NASAA members have worked closely with the SEC and the self-regulatory organizations in maintaining standards of professional responsibility among the great variety of persons engaged in the business of selling securities.

We have taken this opportunity to remind the Task Group of our traditional responsibilities in order to make two points.

First, the Task Group's reappraisal of the goals of avoiding conflicts of interest, fraud, and consumer abuse should not lead to a devaluation of these goals. Our collective experience has convinced us that in these difficult economic times the need for investor protection is as great as it ever was, and that the long-term stability of the capital markets depends on the maintenance of investor confidence through investor protection.

We urge the Task Force to consider that certain inherent conflicts between the goals of "safety and soundness of financial institutions" and "investor protection" may develop as a result of any realignment of Federal regulatory agency responsibilities, particularly when coupled with current market developments. Specifically, the gradual erosion of the traditional barriers between commercial banking and investment banking mandates a coherent government policy insofar as regulatory control is directed toward allocation of risks.

"Safety and soundness" goals should prevail to the extent an institution performs traditional activities wherein the primary economic risk is upon the institution. To the extent an institution engages in securities transactions - activities which traditionally allocate risk predominantly to investors - "investor protection" goals should prevail.

Second, the Task Force's reappraisal should weigh heavily the contribution of the states to the realization of that goal, and should lead to an express endorsement of the states' continuing contributions.

II. Assessment of the Existing Structure

In Paragraph 7 of Part II of the Outline it is asked: "What aspects of the current regulatory system are most important to preserve?" While NASAA has taken no official position on what the reallocation of federal regulatory responsibilities should be, it urges that one major aspect of the existing regulatory structure be preserved.

Stated simply, the existing federal structure requires all securities activities to be regulated as such. In other words, the issuance, offering, sale and purchase of securities is regulated by a federal regimen which places a high value on investor protection achieved through mandatory disclosure of material information. The liabilities associated with material misrepresentation and nondisclosure lend the system of full disclosure considerable force, thereby promoting the exercise of due diligence by issuers and selling persons alike. The federal regimen is complimented by the merit regulation practiced by many of our members, a scheme of regulation which adds a substantial measure of investor protection. NASAA feels strongly that these principles and techniques of securities regulation should be preserved and strengthened in any reorganization of the regulatory scheme.

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Specifically, NASAA believes that if banks, insurance companies and other financial institutions are going to enter the securities field, they should be subject to securities regulation. This is not to say that federal and state securities regulators should ignore the special characteristics of such entities when determining how to regulate them. It simply means that the goals of protecting investors and maintaining the stability of the capital markets mandates preservation of the special characteristics of securities regulation, and not blanket deferral to the techniques used to maintain the "safety and soundness" of banks and other financial institutions.

The attached Committee Report will demonstrate how NASAA has already begun to formulate a policy along these lines for purposes of promoting maximum uniformity in the application of state securities law to emerging financial products and services. We urge the Task Group to consider seriously our recommendation of this approach.

III. Reform Issues and Options

In Paragraph 7 of Part III of the Outline it is asked: "In what...ways should current regulatory controls over securities issuers, underwriters or markets be reduced?" NASAA has long recognized that state and federal regulation of the securities markets produces compliance costs as well as investor protection. Accordingly, NASAA has worked to reduce compliance costs through: (1) promoting uniformity of law and administration among our members, as evidenced by the numerous Guidelines developed by our committees; (2) cooperating with the SEC in the harmonization of state and federal law, as evidenced by the adoption of Regulation D and NASAA's Uniform Limited Offering Exemption; and (3) working with the National Association of Securities Dealers on the creation of a computerized Central Registration Depository for the agents of certain brokerage firms, a device which has substantially reduced the paperwork and associated costs of multi-state agent registration.

NASAA's experience with efforts to reduce compliance costs, however, has shown that the process of cost reduction requires a delicate balancing of the need to reduce compliance costs and the ongoing need for investor protection. In attempting to reduce the costs of securities regulation, therefore, the Task Group should remain aware of the delicacy of this process, and should not allow the rhetoric of "deregulation" to produce simplistic solutions. Furthermore, NASAA would emphasize that our nation's current difficulties with capital formation have much more to do with the obsolesence of our industrial structure, the shortsightedness of our managerial policies, the impact of foreign competition, and the inflation-induced flight of capital from equity to debt, than with the "burdens" of federal or state securities regulation. Indeed, securities regulators can best encourage capital formation by maintaining investor confidence through investor protection.

The foregoing comments reflect NASAA's response to several of the major issues specifically identified by the Outline. We would like to offer an additional statement of concern for the Task Group's concern.

Recent years have witnessed two major steps toward preemption of the states' role in regulation of certain aspects of the financial markets. The first such step was the preemption of state jurisdiction over commodities fraud through the enactment in 1974 of Section 2 of the Commodities Exchange Act. NASAA has stated in testimony before the Subcommittee on Conservation, Credit and Rural Development of the House Agriculture Committee that this grant of exclusive jurisdiction to the Commodities Futures Trading Commission "constitutes a major failure of government in its establishment of regulation to protect investors."

The second step was the Securities and Exchange Commission's promulgation of a rule expressly designed to cause direct preemption of the state takeover statutes. (See SEC Rel. No. 34-16384, [1979-1980] FED. SEC. L. REP. (CCH) ¶82,373, at 82,584.) This action was the culmination of the SEC's refusal to consider the states' point of view with respect to takeover regulation -- a refusal which continues to the present day.

NASAA believes that both of these actions reflect not only disregard for the principles of federalism, but also a failure to appreciate the benefits which a sharing of regulatory responsibilities can provide. We would strongly urge the Task Group to recognize that the sharing of regulatory responsibilities with the states is not a burden, but is rather an opportunity. It is an opportunity to reduce the costs of federal government, and an opportunity to make government responsive to local as well as national needs. Any consideration of proposals to preempt any part of the existing schemes of state regulation should thus be undertaken only with great caution, and with full participation by the appropriate state agencies.

We hope that the Task Group will recognize that any reorganization of federal regulatory responsibilities in response to the changing nature of the financial markets should define and protect an appropriate role for the states, and we request that the Task Group's report reflect that recognition.

Very truly yours,

Richard D. Latham
President
North American Securities
Administrators Association, Inc.

In addition, we are in the process of developing a more detailed and elaborate legal position specifying specific problems that we are now encountering at the state securities level.

Mr. Chairman, I'm going to proceed to present a very shortened version of the full written testimony which I respectfully request be inserted in the record of these hearings.

NASAA is an association of State and Provincial securities administrators from the United States, Canada, and Mexico, which since 1918 has worked for investor protection.

State securities commissioners are charged with promoting investor protection and regulating the securities markets in their respective jurisdictions.

While NASAA recognizes that the basic policy decisions with regard to the entrance of financial institutions into the security industry is basically going to occur at the Federal level.

Preferably that is going to occur here in Congress. To a certain extent it is happening on a de facto basis by the actions of various Federal regulatory agencies, but our point is, we can see that those policy decisions, whether Glass-Steagall should be modified or stripped away, are going to be made at the Federal level.

We are in the position of simply having to respond to and implement many of those changes that occur at the State level, and our concern that we want to advance here today is one that regardless of what the final outcome is we hope that you will put first and foremost, as we do, the concerns of the individual investor. To the extent that we have any constituency, it is that undefined investing public.

With regard to the Glass-Steagall Act specifically—and I think it is a particular honor that we're here today on its anniversary—we would urge this committee and Congress in general to proceed with some degree of caution before they entirely strip away at least the purposes and the spirit of the Glass-Steagall Act.

BARRIERS ERECTED BY GLASS-STEAGALL

The barriers that were erected by Glass-Steagall do not operate or totally preclude institutions from engaging in diverse activities, but rather, simply require that those institutions and organizations are going to have to choose which activity they want to engage in.

So long as they make the choice and they do so in a manner that's going to be designed to continue to emphasize safety and public confidence in banking, as well as to insure the facilitation of raising capital, the concerns of Glass-Steagall can be preserved today.

I don't think it's appropriate for us to get into what the economists are better adept at doing, and that's the discussion of the risk allocations.

Senator Lautenberg has referred to that this morning. We simply note that in our opinion the risks, at least to the traditional investor, are significantly greater than to the depositor in a financial institution.

Accordingly, to the extent that the financial institution assumes those investment services roles, some consideration should be given to the particular risk attendant to that, and the consequential need in our opinion.

I believe this conforms with the testimony of Chairman Shad of the SEC that there should be more disclosure to the public, which is about to assume that risk, than it presently obtains from financial institutions, in particular the banks.

I've heard it characterized as follows: That State securities administrators are where the rubber meets the road. We are in a position to deal with the classic widows and orphans on a daily basis. We are the people they turn to when they have been unable to resolve their customer complaints with a brokerage firm in the traditional sense.

We see the problems that exist when an investor cannot after 6 months of trying, get his stock certificates delivered. We deal with the dispute where a customer comes in and says, "I ordered 200 shares of stock, my broker bought me 300. What do I do? Nobody will listen to me."

So it's in that context that we are concerned that there should be avenues clearly available to investors to redress these grievances.

Under the present scheme of State securities law, which to a large extent tracks the 1933 and 1934 acts, there are broad exemptions or exclusions contained in our laws for banks and other financial institutions.

The net result is that under the present State of affairs, these institutions are able to engage with increasing frequency in a broader range of securities activities without having to comply with the basic provisions of State securities law.

They are, however, still subject to the antifraud provisions of the law, but on these day-to-day problems of dealing with customer disputes, antifraud is simply not a concern.

We would suggest that to the extent the institutions are crossing the Glass-Steagall barrier, that the special status accorded them by these exemptions is no longer appropriate in that sense.

We would support the concept of functional regulation of these activities.

The Federal Government alone cannot handle the front lines of investor protection. If the States are to relinquish their fundamental police power in the interest of public welfare, the Federal system should have the expertise to structure the resources to protect the citizens of those States. Our experience has been in some cases that the response by the financial institutions to our concerns is one of—

> Well, the public will be protected by the Comptroller of the Currency, at least at the national level. They have in place a consumer complaint bureau that handles those problems, rather than having a securities regulator do so.

I've had some informal conversations with the Comptroller's Office to simply try to determine to what extent they are prepared and able to cope with these kinds of problems. While they may disagree with the way I characterize it, I think it's fair to say that they simply do not have the mechanisms in place, the staff resources nor, perhaps, the expertise to deal with complex securities transactions today and to promote an efficient resolution of those disputes.

It is NASAA's position that historically State securities agencies have been the critical enforcement authority for securities. Any dilution of the existing regulatory scheme would be highly counterproductive. From time to time we hear noise about preemption of the States, because of the lack of any real necessity for multiple regulation for these activities.

I would suggest that, while not always successful, our members through our organization have made tremendous strides toward promoting the uniformity of State securities regulation and trying to achieve not only uniformity in and of itself, but to set fairly high levels that will promote investor confidence.

To the extent that there are changes to be proposed legislatively that may require amendment of the Federal securities laws, we would urge you to involve us in those discussions and approach this as a partnership effort by both State and Federal officials.

UNEVEN PATTERN OF LEGISLATION

Legislation permitting financial institutions to directly engage in securities activities, such as the securities activities originally proposed in Senator Garn's act of last year, would cast financial institutions, for the most part, ouside the scope of securities regulatory jurisdiction. This would create an uneven pattern of regulation between traditional securities companies and financial institutions with respect to their securities activities. Requiring securities activities to be engaged in solely by separate affiliates, places both the banking and the securities industries and investors on an equal footing. NASAA, therefore, supports a functional regulation approach that is designed to encourage the use of affiliates only, as a means of doing this.

Proposals for legislation. NASAA believes that the present regulatory scheme has not hampered the prosperity of the securities business, the Nation's capital markets or the economic system in general. At the same time, it has been successful in protecting investors from risks which are deemed illegal and unnecessary, for capital formation. To eliminate the scheme with regard to specific institutions, entering the securities business would be ill-advised, unnecessary, and pose a substantial risk to the integrity of our economic system.

NASAA believes that appropriate safeguards must be part of any action which Congress takes. This would include a requirement that securities-related activities be conducted only through a separate affiliate or a subsidiary. Any proposed legislation should contain strong protection against conflicts of interest, self-dealing and biased resource allocation, which are inherent in the securities business and which provide a basis for the Glass-Steagall Act.

Proposed legislation should also address the need for, in particular, more disclosure by financial institutions and the requirement that those institutions engage in some sort of suitability determination for investors. There are important reasons why NASAA favors an affiliate arrangement for bank securities activities. This form of functional regulation would permit banks to continue to perform the commercial banking functions they historically have performed. They would also be allowed to enter the securities business, but only in a manner similar to that of all other segments of the securities industry and distinctly separate from their banking activities. This arrangement would, in NASAA's opinion, preserve public confidence in the banking system, allow banks to expand into areas of greater risk with appropriate safeguards and maintain a safe competitive atmosphere for the capital-raising activities which are so vital to the economic system.

OVERSIGHT OF BROKER-DEALER FUNCTION

An integral element of Federal and State securities regulation is the oversight of every aspect of the broker-dealer function, beginning with the licensing of the broker-deal firm and its employees, based on their expertise and their education and their demonstrated ability to perform these services, continuing through the point of sale to the execution of the trade and completion of the paperwork in the back office.

Furthermore, the scheme of regulation through its oversight function permits a fairly quick resolution of customer complaints.

In the area of discount brokerage, the elements of securities transactions are frequently divided between one broker acting as a clearing broker and another broker acting as an introducting broker, both of which are subject to securities regulators' oversight. In situations where banks directly take over elements of securities transactions, they are not accountable to these standards of oversight, which are so important for investor protection and preservation of confidence in the markets. And if I could briefly give one example there. In the current situation, it is becoming common for a bank to enter into a contract with a registered discount broker for the purpose of transmitting bank customer orders for execution, usually through a computer hookup or by telephone.

We've had occasion recently to look at very close hand at the insides of some of these contractual relationships and what we're finding is that, by contract, the parties are dividing up the responsibility for the handling of the transaction, and the registered broker-dealer, in some cases, is shifting anywhere from 75 to 90 percent of its general responsibilities onto this bank, and the bank is then charged with supervising the personnel who are involved at the point of sale, insuring that the orders are properly reviewed, and this is all being done without any oversight by securities regulators.

NASAA further recommends that any bank securities affiliate be deemed a broker-dealer within the meaning of the Securities Exchange Act of 1934.

NASAA further believes that the self-dealing and conflict of interest problems which may arise when banks and financial institutions enter the securities business are not solved simply by requiring an affiliate arrangement for those entering the business. Any proposed legislation should provide an effective enforcement mechanism which emphasizes the need for public disclosure violations and imposes personal liability for prohibited misconduct. The interests of investor protection and public confidence in a sound banking system required that areas be addressed.

Mr. Chairman, we appreciate the opportunity to testify today, and I'll be please to answer any questions you may have.

[The complete statement follows:]

STATEMENT OF K. HOUSTON MATNEY, CHAIRMAN OF FINANCIAL INSTITUTIONS, COMMITTEE OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION AND SECURITIES COMMISSION OF THE STATE OF MARYLAND

Members of the Committee, I welcome this opportunity to present the views of the North American Securities Administrators Association, Inc. ("NASAA") concerning the possible impact of the expanded securities activities of banks and other financial institutions, particularly on state securities regulation. NASAA has kept pace with the changes in the market place and each commissioner has been presented with various forms of bank securities activities. In January, NASAA held a Financial Institutions Forum which was attended by state and federal securities regulators, representatives of the banking and securities industries and Congressional staff in order to grapple with this issue. Since that Forum, NASAA has adopted this testimony and has responded to Bush's Task Group on. Regulation of Financial Services. NASAA's Financial Institutions Committee is formulating a legal memorandum detailing the application of state securities laws to the securities activities of financial institutions.

NASAA is an association of state and provincial securities administrators from the United States, Canada and Mexico. Since 1918, NASAA has worked to protect investors, and to ensure that the securities markets operate with a minimum of abuse. State and provincial securities commissioners are charged with promoting investor protection and regulating the securities markets in their respective jurisdictions. NASAA has a strong track record of cooperation with law enforcement officials and with federal agencies.

NASAA has long believed that all regulation should be responsive to existing economic and market conditions. Historically, state securities regulators have responded to abuses in the securities markets which threaten the economic well-being of investors. NASAA submits that the potential for such abuses is not diminished if the securities markets are opened up to financial institutions. The need to protect the public and to foster an efficient investment climate is just as great. NASAA is vitally interested in ensuring that a fair and balanced regulatory approach be maintained to achieve these goals.

NASAA's members recognize that the basic policy decisions in this area will be made on the federal level, but that they will have to meet the consequences of such decisions and implement them in the context of state securities laws. NASAA is not opposed to the recent changes in the market place which have resulted in financial institutions engaging in the securities business, but such position is grounded in the preservation of and adherence to the elements of investor protection which are an integral part of state and federal securities regulation.

I. Current Glass-Steagall Restrictions on Securities Activities of Financial Institutions

The present legislative and regulatory framework separates the investment activities of financial institutions from their traditional role of taking deposits and lending funds. Congress established that framework for specific public policy reasons. Congress recognized that the risk-taking inherent in investment banking, with its emphasis on raising debt and equity capital, was in direct conflict with the national interest in a sound, efficient commercial banking system. Congress also recognized that there was a substantial correlation between national monetary policy and banking operations. Protection against investment-related risks was an avenue toward institutional protection. The many dangers described in the Congressional hearings following the Stock Market Crash of 1929 convinced national lawmakers that the potential harm to banks involved in the securities business far outweighed any benefits to the public. Congress therefore erected barriers designed to allow institutions to choose to function in the field of commercial banking, with its emphasis on safety and public confidence in banking activities, or in the field of investment banking with an emphasis on the riskier function of raising capital in the marketplace.

When a financial institution engages in traditional commercial functions, the institution or its insuring agency bears the primary economic risk. When such an institution undertakes securities-related activities, risks are passed on to the investor. NASAA submits that such a change in the allocation of risk demonstrates the need for stronger investor protection, a policy which should be an integral element of any legislation relaxing restrictions on securities activities by financial institutions. To the extent that investor confidence is diminished, the entire capital system is weakened.

NASAA firmly believes that the policy reasons underlying Congress' decision to divorce commercial banking and the securities business should not be overlooked today when tailoring a legislative response to changing market conditions. A careful look at the economic climate of the last few years strengthens this point.

Two major banks have failed within the last year, sending tremors of uncertainty through the banking system. A government securities firm was forced to declare bankruptcy, saddling one of the country's largest banks with high losses because of its role in expanding credit to the firm. The media is filled with accounts of potential adverse consequences to the international financial system in general, and to certain large banks in the United States in particular, due to the massive extension of credit to developing nations. Such events highlight the need for a painstaking effort to formulate a balanced legislative response which is capable of protecting investors and institutions alike.

II. Divergent Policy Approaches to Banking and Securities Regulation

Permitting banks to engage in a variety of securities activities runs contrary to historical expectations regarding the traditional banking functions. An overriding policy consideration in bank regulation is the protection of depositors. That concern first surfaced in the twelfth century when banks were no longer content to merely act as money-changers but began to accept deposits from the public. The subsequent emphasis in bank regulation on the capital structure of financial institutions, the maintenance of adequate books and records and the examination of banking operations was oriented toward safegarding deposits by ensuring that the institution remained solvent. However, the existing regulatory scheme, which recognizes the special functions historically performed by financial institutions, has been criticized as unduly restrictive. Changing economic conditions and marketplace realities, both domestic and foreign, have prompted industry to aggressively bridge traditional boundaries through merger, acquisition, and internal expansion.

Permitting banks to engage in securities activities creates a hybrid entity which is neither bank nor broker. This would exacerbate the uncertainty already existing in the financial community unless policies are redefined and a balanced system of regulation is put in place.

NASAA recognizes that there is an inherent conflict between the policies supporting banking regulation and those underlying securities regulation. The reason is easily pinpointed. Banks and brokers have traditionally performed different functions. Preservation of solvency, for example, is only an incidental goal in securities regulation while it forms the core of banking regulation.

In addition, the thrust of securities regulation, reflected at both the state and federal levels, has been on full and fair disclosure to investors of all material facts surrounding the securities transaction, including disclosures regarding the persons marketing the securities. By contrast, the regulation of financial institutions has emphasized the safety and soundness of the institution. Confidentiality of bank records has been critical to ensure that public confidence in the stability of the institution was not lost and the institution harmed. Clearly, the philosophies of full and fair disclosure and of confidentiality are at odds. If financial institutions are permitted to engage in securities activities, strict confidentiality must be relaxed and greater disclosure required. As securities customers of banks will bear a greater risk, they should be afforded the protections of full and fair disclosure. On balance, confidence in the capital markets must outweigh confidence in a specific financial institution.

Moreover, when depositor and investor are the same person and one entity is responsible for holding funds safely in custody and putting funds at risk to maximize investment return, banking and brokerage functions must be separated to resolve the competing policy considerations. In this way, it will be possible to safeguard investors and depositors through a dual system of regulation which simultaneously protects both institution and depositor. Assets of the bank, for example, must be segregated from funds invested. In addition, some type of suitability requirement must be applied to bank securities activities; no longer should the implication arise that any investment offered is appropriate for all customers of the bank. The public must also be made aware of the diverse functions performed by banks in order that it does not equate poor market performance with bank performance and thereby lose confidence in the banking institution.

A fair and balanced system of regulation, is essential to reshape public expectations concerning financial institutions. Such a regulatory scheme would also protect investors by enabling authorities to more freely pursue enforcement remedies against financial institutions. The policy of banking regulators to not openly expose banking law violations stems from a need to protect the institution from exaggerated adverse public reaction. This policy can only be preserved if the public's perceptions are molded through sensible regulation and if banks' securities functions are clearly severed from banking functions. Separation of the different functions will make it possible to protect banking customers and securities customers adequately and will help regulators deal with the difficult questions regarding to what extent banking operations should be disclosed to meet the policy objective of investor protection.

III. The Role of State Securities Administrators

Fortunately, the regulatory framework for achieving these objectives already exists. When Congress decided to strictly limit bank securities activities in the 1930s, it also reformed the securities business in general. Congress determined that securities activities should be regulated more closely. The Securities and Exchange Commission was created and a series of laws were enacted to regulate securities firms, including investment companies, broker-dealers and investment advisers. The Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisors Act of 1940 and the Investment Company Act of 1940 all exempted banks from their scope. The broad exemption for banks was based upon Congress' assumption that no compelling reason existed for including banks in this regulatory scheme since their securities activities were sharply curtailed by the Glass-Steagall Act - an assumption which is no longer valid.

The same reasoning prevailed at the state level. The Uniform Securities Act, which bears many similarities to the federal securities laws, also affords special status to banks and other financial institutions with regard to certain registration requirements, but still subjects them to antifraud jurisdiction. This special status is not justified when financial institutions become the functional equivalents of securities broker-dealer. NASAA is aware of continuing federal efforts to evaluate the need for comprehensive regulatory reform and consolidation. NASAA believes that the states' legitimate interest in the public health, safety and welfare of their citizens should be recognized in any federal regulatory scheme imbued with a national public interest.

Investor protection is a major cornerstone of federal and state securities laws. Investors directly and indirectly provide capital for capital formation and are the collective source for the funds which the economy needs to operate. Investor confidence or lack of confidence in our financial institutions and capital markets controls the health and growth of our economy, and, in turn, the economies of the international community.

NASAA's mandate with respect to investor protection extends to all investors, regardless of the type of entity through which they purchase securities. Protecting investors from the illegal wasting of their private property and preserving the nation's primary capital resource is vital.

Whether the federal government can adequately handle the front lines of investor protection alone is a question which must be asked and answered with respect to any potentially preemptive regulatory scheme. NASAA says "no" because it is aware of the economic realities of effective regulation and the enforcement realities of effective investor protection. No regulation is useful unless it can be effectively administered. If states are to relinquish their fundamental police power in the interests of a unified system of regulation and enforcement, the federal system should at least have the expertise, the structure and the resources to protect the citizens of those states.

It is NASAA's position that historically state securities agencies have been the critical enforcement authority for securities related misconduct. In particular, state securities administrators have the wherewithal and the incentive to take enforcement measures where violations of the securities laws have occurred. Investors generally look to their state officials to undue any wrong inflicted on them in the securities market. Any dilution of the existing regulatory scheme would be highly counterproductive.

Investor protection under state securities laws includes not only effective enforcement but adequate disclosure and fair sales practices through state registration and licensing procedures. Some industry members have sought to promote federal preemption of securities regulation of financial institutions, pointing to (1) lack of uniformity in state regulation (2) inflexibility in state regulation with respect to new and changing products (3) market delays and losses from dual sovereignty and (4) increased costs of capital formation from dual sovereignty. Dual sovereignty, however, is inherent in our system of government. Moreover, financial institutions have traditionally been subject to concurrent regulation. Centralized regulation in this context is not only unwieldy but unrealistic. Investors and financial institutions deserve no less than the responsiveness to their needs that state oversight can provide. In addition, the level of uniformity in state regulation is much higher than 50 different approaches. Particularly with the Uniform Securities Act and through NASAA, state securities commissioners are dedicated towards achieving high levels of uniformity.

Those advocating preemption are the same persons who solicit investor resources to promote capital formation. Their interests are spoken for. Any integrated regulatory scheme, however, cannot afford to overlook the states' role in investor protection, particularly with the limited enforcement resources at all levels of federal government. With severe cutbacks in the federal budget, it is questionable whether federal authorities can responsibly regulate bank securities activities by themselves. A partnership with the states is essential and should be an integral part of any regulatory scheme.

Legislation permitting financial institutions to directly engage in securities activities, such as the securities activity proposal originally in the Garn Act, would cast financial institutions, for the most part, outside the scope securities regulatory jurisdiction and subject investors to different levels of protection depending on who they do their securities business with. Needless to say, this would create an uneven pattern of regulation between traditional securities companies and financial institutions with respect to engaging in the same activities. Requiring all financial institutions' securities activities (other than traditional banking securities activities) to be engaged in through a direct subsidiary or a holding company subsidiary, as proposed in S.879, places the banking and securities industries and investors on equal footing with regard to securities activities. NASAA sees no justification for stripping investors of the myriad of protections which are at the heart of federal and state securities regulation merely on the basis of which entity they choose to deal with, and, rather, supports a "regulation by function" approach. To do otherwise would expose the public and the economic system to needless risks, including the abuses which prompted the enactment of the Glass-Steagall Act.

The theme of NASAA's last annual meeting attended by state, federal and industry representatives, was "Partners in Regulation." This slogan recognizes the need for a coordinated and cooperative approach to state and federal securities regulation to meet changing industry and economic conditions. It recognizes that the costs of regulation must be shared to maintain an effective level of law enforcement in investor protection and market integrity, whether accomplished at the state, regional, or federal level, or within the securities industry's self regulatory structure. No one regulatory authority is able to bear the total cost and responsibility for investor protection in the context of worldwide financial markets. An integrated system is required.

The securities markets and activities of today are strikingly different from those of the 1930's. Today, most financial institutions are either entering the securities business in some manner or giving the matter serious consideration. These activities, and the various methods which have evolved to implement them, are occuring almost daily. That is not to say that these events are unhealthy. These events are the result of significant changes that have evolved in the capital markets of this country, particularly in the last few years.

It is NASAA's desire, as it is the desire of all securities regulators, that the investor be the recipient of the obvious benefits resulting from enhanced, healthy competition in the securities business. With the merger of the banking and securities markets; with the elimination of legislatively imposed restrictions on the activities of financial institutions; and with the conflict in laws inevitably resulting from a broad scale assimilation of regulated activities, Congress has been asked and will be asked again, to correct discrepancies in regulation which restrict competition or interfere with the free flow of commerce. The integrity of the financial markets should not be jeopardized by uneven or discriminatory regulation. This is particularly true if investor protection is absent from any segment of the market.

IV. Proposals For Legislation

NASAA believes that the regulatory scheme contained in the state and federal securities laws has not hampered the prosperity of the securities business, the nation's capital markets or the economic system generally. At the same time, however, these regulatory checks have been successful in protecting investors from risks which are deemed illegal and unnecessary for capital formation. Any legislative scheme which would upset this regulatory balance by allowing banks and other financial institutions to enter the securities business in an unregulated fashion would be ill-advised, unnecessary, and pose a substantial risk to the integrity of our economic system.

NASAA firmly believes that appropriate safeguards must be a part of any action which Congress takes in allowing financial institutions to enter the securities business. NASAA submits that such safeguards include a requirement that securities-related activities be conducted only through a separate affiliate or subsidiary. In addition, any proposed legislation should contain strong protection against the conflicts of interest, self-dealing and biased resource allocation which are inherent in the securities business and which provided the impetus behind the Glass-Steagall Act. A flat prohibition against biased resource allocation, however, would not be sufficient. Rather, limitations should be imposed based on the size of affiliates. Limitations on the amount of debt between institution and affiliate should also be considered along with a prohibition on the sale of assets between related entities. Proposed legislation should also address the need for (1) asset segregation (2) more disclosure by financial institutions and (3) suitability requirements for investors.

There are important reasons why NASAA favors an affiliate arrangement for bank securities activities. This form of functional regulation would permit banks to continue to perform the commercial banking functions which they have historically performed. They would also be allowed to enter the securities business, but only in a manner similar to that of all other segments of the securities industry and distinctly separate from their banking activities. This arrangement would, in NASAA's opinion, preserve public confidence in the banking system, allow banks to expand into areas of greater risk with appropriate safeguards, and maintain a safe, competitive atmosphere for the capital-raising activities which are so vital to the economic system.

An integral element of federal and state securities regulation is (1) the oversight of every aspect of the broker-dealer function from the licensing of the broker-dealer firms and their agents, based on their expertise and education, through the point of sale and to execution of the transaction in the back office and (2) the ability to, through such oversight, to facilitate resolution of customer complaints. In the area of discount brokerage, the elements of a securities transaction are divided between the discount broker and the clearing broker, both of which are subject to securities regulators' oversight. In situations where banks directly take over of securities transactions, they are not accountable to these standards of oversight which are so important to investor protection and the preservation of confidence in the capital market.

NASAA further recommends that any bank securities affiliate be deemed a broker or dealer within the meaning of the Securities Exchange Act of 1934 and/or an investment adviser within the meaning of the Investment Advisers Act of 1940. NASAA believes that the present dual regulatory system for investment banking and commercial banking should be preserved. This recommendation would help to minimize any doubts on the part of the industry, regulatory agencies and the public as to the precise legal duties and responsibilities of bank securities affiliates.

NASAA further submits that the self-dealing and conflict of interest problems which may arise when banks and financial institutions enter the securities business are not solved simply by requiring an affiliate arrangement for those entering business. The temptation to tie favorable credit arrangements to securities customers, and to loan funds to shore up sagging securities affiliates and firms in which a bank may underwrite equity capital, are compelling reasons for placing strong provisions against such conduct in any proposed legislation. In addition, any proposed legislation should provide an effective enforcement mechanism which emphasizes the need for public disclosure of violations and imposes personal liability for prohibited misconduct. The interests of investor protection and public confidence in a sound banking system require that these areas be addressed.

NASAA appreciates being invited to testify today and would be pleased to furnish any information which the Committee may request.

Senator HECHT. Thank you very much. It's very self-explanatory. There is one question I have from your testimony. I didn't understand exactly—I will quote from you. You would support the "functional regulations of activities." Specifically, what do you mean by that?

SUPPORT FUNCTIONAL REGULATIONS OF ACTIVITIES

Mr. MATNEY. Well, Mr. Chairman, I think I can amplify on that statement a little bit. I would say that the basic core of this testimony was prepared some months back. It was adopted by our membership at our spring meeting. At the time, we weren't exactly sure what proposals were going to be before Congress. We now have the opportunity to at least see the Chafee bill. We have had the benefit of the Secretary of the Treasury's testimony, so we have some more solid notion of what the Treasury Department is thinking about. And what we mean by that is, No. 1, accepting that the policy decision is going to be made here in Washington, and that it's probably coming, we would support the concept of entry of the financial institutions into the securities business, provided that it is done so in a manner that would require regulation by function, and since the function is security in nature, presumably, that would require in appropriate instances, registration at the State and Federal level, and insure that the regulatory oversight inherent in the securities laws would be applicable.

That would occur, of course, pretty much in a natural fashion here. If the only Federal change was to mandate that these activities be conducted through affiliates, in which case, the affiliates, unlike the core institution, would not be exempt from the securities law.

Senator HECHT. Excuse me, in your testimony, you refer to the potential for banks to tie favorable bank credit arrangements to their affiliated securities products.

Would you please submit to the committee a draft of what NASAA considers to be an effective anti-tie-in provision. Would you comment on that.

Mr. MATNEY. Senator, I'm not sure that I am really in a position to comment on that today. but we will be glad to submit written recommendations to the committee on that point.

[Information subsequently submitted for the record follows:]

North American Securities Administrators Association, Inc.

Restrictions on Transactions Between Affiliated Financial Institutions and Securities Firms or Investment Companies

During our testimony before the Senate Committee on Banking, Housing and Urban Affairs on June 16, 1983, it was requested that we submit some suggestions with regard to restrictions on transactions between affiliated financial institutions and securities firms or investment companies ("Affiliates").

1. Require non-preferential terms on loans or other extensions of credit between Affiliates.

2. Establish low percentage of assets limitations on investment by one Affiliate in another, recognizing, however, that one Affiliate may still be liable for the debts of another under controlling person liability.

3. Prohibit "double use" of capital on a consolidated basis to meet net capital requirements.

4. Require non-preferential terms and independent appraisals on sales of assets between Affiliates, however, prohibit transfers of undervalued assets.

5. Require non-preferential treatment for the payment for or furnishing of services by an Affiliate or in any other transactions in which an Affiliate directly or indirectly derives a benefit.

6. Strict limitations should be placed on joint advertising to avoid public confusion as to whom is offering the services being advertised.

7. Prohibit the fiduciary department of a financial institution Affiliate from purchasing, or advising purchase of, securities underwritten by securities Affiliate or acting as custodian for a securities Affiliate.

8. Prohibit the extension of credit or fiduciary department involvement with any company whose securities are being underwritten by a securities Affiliate.

9. Prohibit margin loans on any securities underwritten by an Affiliate.

10. Prohibit the acceptance as collateral for loans any securities underwritten by a securities Affiliate.

Senator HECHT. Later this morning, we will hear testimony from SIA and the ICI, expressing their concern with tie-ins, and the fact that tie-ins lead to concentration of power.

In your opinion, would an effective anti-tie-in provision significantly reduce the prospect for concentration of power in a number of money center banks?

Mr. MATNEY. Senator, I have to preface any remarks in that regard with an observation. There was a Broadway musical back in the late fifties by the name of "Tenderloin." There was a song in that musical called "See How Money Changes Hands." NASAA is not here today carrying a brief for the securities industry or any other entity, regulated or otherwise. We recognize that there are strong potentials for the types of abuses that Senator Glass addressed 50 years ago to recur. Certainly a concentration of money in large institutions and the tie-in problem can occur. My personal—and in this context, I think I ought to say it is a personal statement, is that those problems can be addressed, I would think, in your legislation, by including specific prohibitions, where appropriate, and providing for specific sanctions and some degree of strong liability, if they're violated.

Senator HECHT. In other words, there is no legislative remedy. Anyway, we'd appreciate your help and your comments on that, you can address later.

NONMEMBER BANKS ENGAGE IN SECURITIES ACTIVITIES

As you may know, the FDIC permits state-chartered, nonmember banks to engage in securities through a bank subsidiary. Do State securities laws protect the bank securities subsidiaries customers, investors?

Mr. MATNEY. In the case of these activities being conducted through subsidiaries or affiliates, it is our position that our laws, with perhaps some exceptions around the country, but for the most part would be fully applicable. Those activities could only be conducted in compliance with the existing scheme of State securities laws, and for the most part, we can accommodate within our scheme of regulation these changes. There are several aspects though of the FDIC proposal that present concern for us and may bring to a head the inherent conflict between the scheme of banking regulation and the scheme of securities regulation. For example, the age-old problem of the bank that is the recipient of a cease-and-desist order from a bank regulator for conducting unsound banking practices. That traditionally is a sanction that is kept in the closet. The public is not aware of that.

A bank subsidiary which is engaging in broker-dealer functions, on the other hand, is required, to a certain extent, publicly, and in any event, to a regulatory agency, to provide immediate and current updates on any adverse actions that have been taken against it or that may have an adverse impact upon its financial position.

Under prevailing notions of the securities laws, a lot of people are subject to those disclosures other than the registered entity, for example, an affiliate or an associate of that person. It is possible that a bank, in this case, a State bank which has been targeted by bank regulators for enforcement action, would be deemed an affiliate of that securities broker-dealer and, therefore, would be forced by the securities laws to disclose that information, simultaneously be forced by the banking laws not to disclose that. I don't know how we deal with that problem when and if it comes, but we recognize the potential for it.

Senator HECHT. One last question. Many of the securities firms offer cash management accounts which permit customers to write checks on their money market funds. To the extent that we're looking to provide functional regulation, shouldn't we consider imposing reserve requirements on these accounts, as well as limiting the ability of the firms to market these accounts across State lines?

Mr. MATNEY. Senator, again, I will have to respond with a personal observation, wearing my hat as Maryland Securities Commissioner in this context. I personally have told the Investment Company Institute on prior occasions that in my personal opinion when they engaged in those services they were engaged in commercial banking. I further advised the Banking Commissioner in my State that I thought he was perfectly within his rights if he proceeded to require regulation of those activities as a banking function.

The bottom line is that's a problem for the bank regulators. I can only deal with the securities activities. But that may have been the first bullet that was fired in this war.

Senator HECHT. I appreciate your frankness. Senator Lautenberg.

Senator LAUTENBERG. Your interest is, as a regulator, to make sure the public is protected when they invest in securities, and in your testimony you say—and here we might paraphrase a little bit—the State securities industry is an indispensable element of the regulatory system. Investors should look first to the states for protection.

The problem is that as various of the States hunger for business, we see regulations being written that are more directed toward getting home office or branch office locations to escape regulation. We have an example in South Dakota, of course, where what they have done is said that banks there can write insurance acceptance in South Dakota. I'm not picking on South Dakota. What I am simply doing is using that as a framework.

Do we really protect the investor if we don't have a Federal scheme that says these are the conditions that must be observed, at a minimum? I don't think, Mr. Matney, that we give the investors the protection you see, and I think properly, if the first line of defense is exclusively the State regulatory agencies.

Do you want to comment on that?

Mr. MATNEY. Senator, I think, again speaking as the Maryland Securities Commissioner and not necessarily for NASAA, I keep making this qualifier in my remarks, but on these issues as a whole, and as reflected in our basic testimony here, we have as close to complete unanimity on the subject as I have seen among State securities administrators. So I do feel comfortable addressing the basic areas as a spokesman for all of us.

On this particular point, I would agree with you personally that the basic standards, the policy decisions, the basic safeguards, have to be built in at the Federal level. We can do nothing more than react or respond by greater or lesser methods of implementation of those standards at the State level.

COMPETITION BETWEEN STATES TO REDUCE REGULATIONS

Senator LAUTENBERG. What's getting into the competition between States is a tendency to reduce the requirements and invite the company, whatever that is—a bank or otherwise—to come on in there. And as a consequence, in order to make that easier, you have got to kind of lower the standard for the investors, because it gets too complicated, too much reporting, too many bureaucrats, too many costs, et cetera. I am concerned about that.

I want to ask you something else here. When you talk about separate subsidiaries, you define "subsidiary" as the kind of place where these things ought to be parked, as opposed to an affiliate. I think you afford some protection to the affiliate, because, as I understand what you're saying, you can't really keep it clearly defined, clearly separated.

But I think the purpose of some of this is to make capital available—oh, we've got a vote. Would you want to break?

Senator HECHT. When they have the second bell, would you excuse us for a few minutes? We will vote—we will adjourn for about 10 minutes, and be right back. So when the second bell goes, your time's up.

Senator LAUTENBERG. OK. The fact is that the purpose of some of this is to make available capital for various opportunities, not simply to engage in another business, but to be able to switch capital, and whatever the rules are, we know they are broken often and the vigilance is required. Are we kidding ourselves when we talk about separating these things, when ultimately the purpose is to concentrate capital and concentrate power into a financial institution that has all kinds of problems?

Mr. MATNEY. Senator, at the risk of not responding directly, it has been suggested by a public official in my State that maybe the best thing to do, from a regulatory standpoint, and maybe even from a policymaking, legislative standpoint, is simply to go sit on the sidelines, and that the developments in the marketplace will resolve a lot of these issues.

Some of the activity we saw 1 year ago, even 6 months ago, is no longer there. The retail repurchase agreements that were popular last year, very few if any financial institutions are offering those today. You know, how do you devise a legislative response to something that is happening as rapidly and as fluidly as this is? It is beyond my expertise to really address the concentration of economic power, if you will, aspect of this. I appreciate the fact that you have to.

Senator LAUTENBERG. I don't approach it from that standpoint. I am concerned about the concentration, as the chairman said before, the concentration of capital in too few hands. I really think that it ultimately augers very poorly for our society. This country of ours, with its entrepreneurship, was built on capital available in small pieces in all kinds of locations. I think we run a great risk of losing that flexibility, of losing the stimulation for investing and risktaking.

But what I am talking about here is I have some knowledge of the securities business, I have some knowledge of the banking business—probably too little to really qualify me as an expert, but I am going to try, anyway. And when I see your concerns about keeping these funds separate from commercial banking on one side and investment banking on the other, I think we are kidding ourselves, that we can put them under the same roof.

Senator HECHT. We will recess to the call of the Chair, which means as soon as we can get back.

[Recess.]

Senator HECHT. Thank you all for your indulgence, and to start the second half on a humorous note, if you're wondering why we had a vote, I'll tell you what the vote was. It was a vote to increase Senators' salaries to $100,000 a year. And I did not get the final tally, but I think it went down to defeat. [Laughter.]

I saw only two or three for it. Senator Lautenberg I don't think will be back, and so we thank you for your testimony. We are going to go right on along, because we have got a busy morning. We are going to keep right on going.

May we have the first panel, please? Robert E. Linton and David Silver.

OPENING REMARKS OF SENATOR HEINZ

Senator HEINZ [presiding]. Gentlemen, I welcome your panel to the committee. Exercising the privilege of the gavel, there are a few basic remarks I would like to make, if you'll permit me, before you make your statements. As I think everybody in the room is well aware, Senator Garn and the committee have been holding oversight hearings on the financial services industry for quite some time, and it is coincidental—even ironic—that today is the 50th anniversary of some very important legislation, the Glass-Steagall Act, which created a barrier between banking and commerce. That legislation was enacted out of our concerns about the intermixture of banking and commerce, and the causalties that were suffered in the economy in the 1930's.

As we sit here, Congress has made considerable progress to date on legislation to restructure the financial services industry. The enactment of the Garn-St Germain Act last year, in 1982, was a significant first step and, to my mind, clearly demonstrates the intent of Congress to take responsible action in this area.

Last year, when we passed Garn-St Germain, there was a very broad, bipartisan consensus that further legislation needed to be enacted, and both the House and Senate have begun the process of deciding and studying the alternatives. The legislation to provide an orderly transition to a stable yet less regulated marketplace, however, is threatened, at least in this member's judgment, by financial institutions, Federal regulators, and State legislators which are attempting to reconstruct the chaotic, fragile, unregulated pre-Depression financial system through the use of loopholes in Federal statutes.

I do not believe that it would be prudent for Congress to forgo the opportunity that now exists to produce sound, forward-thinking legislation firmly based in public policy. Indeed, if Congress does not respond intelligently, we could easily face a recurrence of the economic and social tragedy that followed the crash of the interwoven financial system during the Depression. But it is very important that we have the right kind of action, and the issues and dangers involved here are highly technical and complex. Congress, as stated in the recent GAO study, still lacks much of the information it will need to make public policy decisions in this area.

We do not as yet fully understand the impact of the enhanced competition provided by last year's Garn-St Germain legislation, nor do we understand the vulnerability of the economic recovery; we don't know how long, how far it is going to last or go; and we do not fully understand the implications of the many currently weak financial institutions to any changes we might precipitously make. So the potential for costly mistakes if we act precipitously is a great danger.

Congress needs time and should take the time to act cautiously and thoroughly, time that it will not have if every financial institution is forced to move through the loopholes in order to prevent placing itself at a competitive disadvantage. If competitive panic is allowed to exist while Congress sits in deliberation, restructuring will be far more difficult and socially costly to accomplish.

Our progress will be slow. Congress will face the difficult decision of whether or not to grandfather so many institutions as we had to do with the International Banking Act so as to render the legislation ineffective or to trap companies that meant no harm into forced divestitures and other problems.

Furthermore, it would be difficult if not impossible to resurrect the local banks, savings and loans, and other small institutions that are gobbled up across state lines and industry lines, or those that simply get trampled out of existence in the panic.

It is literally true that the ink wasn't dry on title VI of Garn-St Germain in 1982—which restricts bank holding company insurance activities—before South Dakota signed into law provisions which would enable such companies to circumvent clear congressional intent. What will become of our ability to legislate in these areas if state legislate loopholes, as did South Dakota, and others promise to do, to undo the effect of Federal restructuring of laws, as soon as we pass them?

In this Senator's judgment, Congress must retain control over the financial services industry's restructuring process. To do so, Congress must place a moratorium on the exploitation of loopholes in Federal statutes that place the insitutions beyond the standards of existing public policy.

It is this Senator's judgment that the public interest is not served by self-interested parties, Federal regulators, or State legislators that threaten the public with a breakdown of the system that has functioned effectively for 50 years because Congress will not or cannot develop a timetable to suit them.

And to those who feel that it would be somehow imprudent or unwise of Congress to take the time to do the job right, I would answer that no harm or danger has been demonstrated if Congress were to take sufficient time to deal carefully with these issues of far-reaching consequence. I do not believe any defense can be made for the use of these loopholes on substantive grounds, and Congress must not be placed in the position of having to act precipitously in order to protect the public from these excesses.

I say, again, that in this Senator's judgment, Congress should reject such blackmail and impose a carefully drafted and well thought out moratorium on the exploitation of loopholes in Federal financial services legislation, and I am prepared to work with Chairman Garn and other members of the committee to draft, achieve, and introduce exactly such a moratorium.

I would like to introduce for the record letters from the following organizations indicating their support for a moratorium.

Without objection, the letters from the American Land Title Association, the Independent Bankers Association, the Independent Insurance Agencies, the National Association of Casulty Insurance Agents, and the National Association of Life Underwriters, the Professional Insurance Agents and the Securities Industries Association will be entered in the record at this point.

[The following letters were subsequently supplied for the record:]

AMERICAN
ASSOCIATION
OF RETIRED
PERSONS

July 20, 1983

The Honorable John Heinz
United States Senate
Washington, D.C. 20510

Dear Senator Heinz:

The American Association of Retired Persons is pleased to endorse S. 1532, which would provide more time (until December 31, 1983) in which to study the merits or demerits of diversifying the financial services offered by commercial banks (and other institutions with commercial banking powers).

The Association is frankly concerned with the diffusion of the controls of the federal government over the powers of commercial banks to create deposit money and with the weakening of competition for commercial bank credit, when commercial banks become linked closely with other institutions providing non-bank types of financial services. Although it has been claimed that deregulation of banking activities will produce no ill effects because of competition, it seems likely that mergers and very large institutions would be favored, with uncertain consequences for the stimulation of competition.

Elderly depositors with passbook savings accounts have gone through more than a decade during which they have rarely received any real rate of interest on their accounts. The competitive aspects of deregulation need careful appraisal. We do not wish to see a headlong rush into deregulation of financial services with no clear idea of the consequences.

Sincerely,

Peter W. Hughes

Peter W. Hughes
Legislative Counsel

PWH:RWB

cc: Paul A. Volcker, Chairman
Board of Governors of the Federal Reserve System

Arthur F. Bouton
AARP President

Cyril F. [illegible]field
Executive [illegible]ector

National Headquarters 1909 K Street N.W. W[illegible] 20049 [illegible] 8[illegible] 4700

AMERICAN
LAND TITLE
ASSOCIATION

1828 L Street, NW
Washington, DC 20036
202/296-3671

June 15, 1983

The Honorable John Heinz
277 Senate Russell Office Building
Washington, DC 20510

Dear Senator Heinz:

On behalf of the American Land Title Association, the national trade association of the land title industry*, I would like to express our Association's support for legislation that would place a federal moratorium on state legislative banking initiatives that undermine the intended purpose of existing federal banking law.

Our Association strongly supported Title VI of the "Garn/St Germain Depository Institutions Amendments of 1982" that placed reasonable limitations on the insurance-related activities of bank holding companies and their affiliates. However, deliberate efforts are underway to circumvent Title VI limitations and thwart the will of Congress. Several large bank holding companies have "thumbed their nose" at congressional banking policies and are lobbying several state legislatures to process legislation that enables state chartered banks to engage in insurance activities presently foreclosed to bank holding companies.

The centerpiece of any comprehensive policy determinations in restructuring the financial marketplace must adhere to the principles of safety and soundness. The enactment of a federal moratorium measure would give Congress an opportunity to carefully consider fundamental and comprehensive banking reform. One stop shopping, the advent of computer technology, financial service acquisition hybrids, and bank marketing innovation all must be secondary to the mainstay of our banking system-- the safety and soundness of depositors' money.

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* The American Land Title Association (ALTA) represents nearly 2000 land title insurers, title insurance agents, abstracters, and associate members throughout the nation. The function of the Association's members is to provide for the safe and secure transfer of and investment in real estate.

Of particular interest, ALTA is extremely concerned with the conflict of interest potential when banks, savings and loans, and other financial intermediaries are permitted to engage in the business of insurance. Lending institutions such as those affiliated with bank holding companies, have significant power to influence or control a borrower's decision on the selection of a provider of insurance services related to the extension of credit. This is particularly true in the case of title insurance, which is generally purchased only in connection with a real estate transaction and with the extension of credit related to the financing of such a transaction. Since the average consumer may purchase real estate only once or twice in his lifetime, and lacks the time, knowledge, or experience to shop effectively for such insurance, the lender is in a strong position to influence the consumer to place his title insurance business with a company owned by or affiliated with the lender. Accordingly, we believe that the limitations contained in Title VI of the Garn/St Germain Act are necessary to insure that all providers of insurance will have a fair and equal opportunity to compete for the borrower's insurance business and that a free and competitive marketplace will be maintained for such insurance.

ALTA strongly endorses the federal moratorium initiative and urges the Senate Banking Committee to promptly reassert its prerogatives to insure that the limitations set forth in Title VI of the Garn/St Germain Act are not compromised by the adoption of inconsistent state laws.

Sincerely,

Tom McDonald

Tom McDonald
President

CONFERENCE OF STATE BANK SUPERVISORS

OFFICE OF THE PRESIDENT

June 14, 1983

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Washington, D.C.
[illegible]
JOSEPH E. JONES
Washington, D.C.
Vice President

Honorable John Heinz
Room 469
Russell Senate Office Building
Washington, D.C. 20510

RE: Non-Bank Bank Moratorium

Dear Senator Heinz:

In my recent testimony before the Senate Banking Committee, I referred to a Congressional solution to the "non-bank bank loophole" as the number one short-range priority for CSBS (see attachments). As you know, that loophole allows entrepreneurs to circumvent the will of Congress by acquiring and operating banks without regard for the Bank Holding Company Act or controls over the mixing of banking with other lines of commerce. Regulatory steps taken by federal agencies have proved insufficient to prevent continued use of the loophole, thus underscoring the need for immediate Congressional action.

It is our understanding that you will sponsor legislation to place a moratorium on continued use of the non-bank bank loophole, pending Congressional fashioning of a permanent solution. CSBS supports you in your effort to restore purpose to the statutory scheme designed by Congress.

If the Conference can be of any assistance to you in this matter, please do not hesitate to call on us.

Sincerely,

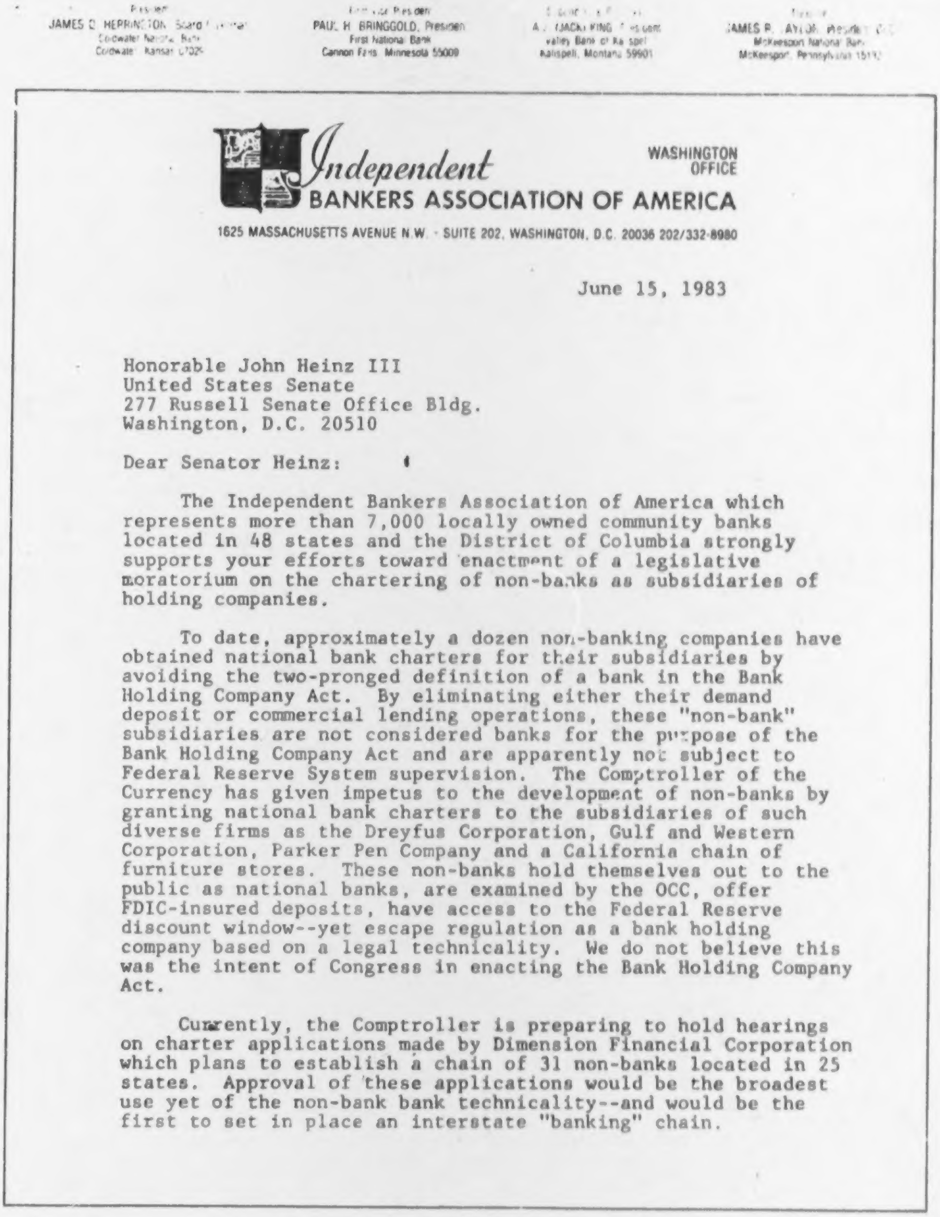
Sidney A. Bailey

Sidney A. Bailey
President

SAB:drj

Attachments

1015 EIGHTEENTH STREET, N.W. • WASHINGTON, D.C. 20036 • (202) 296-2840



President
JAMES D. HERRINGTON, Board Chairman
Coldwater National Bank
Coldwater, Kansas 67029

First Vice President
PAUL H. BRINGGOLD, President
First National Bank
Cannon Falls, Minnesota 55009

Second Vice President
A.J. (JACK) KING, President
Valley Bank of Kalispell
Kalispell, Montana 59901

Treasurer
JAMES R. TAYLOR, President, CEO
McKeesport National Bank
McKeesport, Pennsylvania 15132

Independent BANKERS ASSOCIATION OF AMERICA
WASHINGTON OFFICE
1625 MASSACHUSETTS AVENUE N.W. · SUITE 202, WASHINGTON, D.C. 20036 202/332-8980

June 15, 1983

Honorable John Heinz III
United States Senate
277 Russell Senate Office Bldg.
Washington, D.C. 20510

Dear Senator Heinz:

The Independent Bankers Association of America which represents more than 7,000 locally owned community banks located in 48 states and the District of Columbia strongly supports your efforts toward enactment of a legislative moratorium on the chartering of non-banks as subsidiaries of holding companies.

To date, approximately a dozen non-banking companies have obtained national bank charters for their subsidiaries by avoiding the two-pronged definition of a bank in the Bank Holding Company Act. By eliminating either their demand deposit or commercial lending operations, these "non-bank" subsidiaries are not considered banks for the purpose of the Bank Holding Company Act and are apparently not subject to Federal Reserve System supervision. The Comptroller of the Currency has given impetus to the development of non-banks by granting national bank charters to the subsidiaries of such diverse firms as the Dreyfus Corporation, Gulf and Western Corporation, Parker Pen Company and a California chain of furniture stores. These non-banks hold themselves out to the public as national banks, are examined by the OCC, offer FDIC-insured deposits, have access to the Federal Reserve discount window--yet escape regulation as a bank holding company based on a legal technicality. We do not believe this was the intent of Congress in enacting the Bank Holding Company Act.

Currently, the Comptroller is preparing to hold hearings on charter applications made by Dimension Financial Corporation which plans to establish a chain of 31 non-banks located in 25 states. Approval of these applications would be the broadest use yet of the non-bank bank technicality--and would be the first to set in place an interstate "banking" chain.

These developments obviously have major implications for laws regarding the separation of banking and commerce and the prohibition on interstate ownership of banking organizations. We believe these important public policy issues should be addressed by Congress, rather than dealt with by the regulatory fiat.

IBAA urges Congress to act immediately on a legislative moratorium. The Comptroller of the Currency has adopted a temporary moratorium to "reduce the pressure of escalating marketplace innovation at the national level that could outpace Congressional deliberation." However, he exempted the Dimension application, among others, from the moratorium, and absent legislative action, he could rescind his regulatory moratorium at any time. Congressional examination of the broad implications for competition, concentration of financial resources and the erosion of the traditional barriers between banking and commerce can only be effectively achieved by suspending the current confusion in the marketplace.

We appreciate your efforts and concern regarding this critical issue.

Sincerely,

James D. Herrington
President

Independent Insurance Agents of America
INCORPORATED

SUITE 200
600 PENNSYLVANIA AVE. S.E.
WASHINGTON, D.C. 20003
202/544-5833

Roger N. Levy
Director of Federal Government Affairs

June 14, 1983

Senator John Heinz
Room 469 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Heinz:

In our testimony June 7, IIAA urged the Senate Banking Committee to take immediate action to forestall bank holding company circumvention of insurance restrictions adopted by the committee and Congress less than nine months ago. We are writing today to reiterate our request for prompt committee action, and to urge your support for a moratorium on certain financial institution activities as the best, quickest way to give the committee the time it needs to examine more comprehensive reform.

IIAA endorsed, and others submitted to the committee in connection with the insurance agents' June 7 testimony, a draft moratorium (copy attached) for your consideration. This moratorium would address in an equitable, comprehensive way most of the ambiguities in federal banking law and regulation now being used to dismantle our federal banking system without the benefit of Congressional review and decision.

As we noted in our June 7 testimony, it is not enough, in the context of banking, to look approvingly on the innovation of the marketplace or the legal ingenuity of our nation's largest banks. Congress must either determine that certain changes are in the public's interest, or, if they are not, must set limits that are relevant to the day to day conduct of banking.

The risks to depositors' money, the federal treasury, and the future viability of our banking system are simply too great to continue to permit individual state laws and regulatory activism usurp Congressional prerogative for a more careful review of banking issues.

Again, we urge you to support, and to seek prompt committee action on, the attached moratorium. I'd be happy to discuss this proposal further with you or your staff at your convenience.

Sincerely,

Roger Levy

Roger N. Levy

RNL:gg

Enclosure

cc: Independent Insurance Agents of Pennsylvania

Investment Company Institute
[illegible] K STREET N. W. WASHINGTON D. C. [illegible]
[illegible]

DAVID SILVER
PRESIDENT

June 15, 1983

The Honorable John Heinz
United States Senate
469 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Heinz:

We are writing to inform you of our support of a legislative moratorium on further ad hoc integration of the financial services industry for a period of time that would give Congress the opportunity to consider a comprehensive legislative approach.

We are particularly concerned that recent actions by federal bank regulators represent unprecedented attempts to reverse public policies of many years standing through agency action. Instead of interpreting the laws to effectuate Congressional purpose, these agencies have decided to substitute their judgment as to appropriate public policy for that of the Congress.

As you know, your Committee is currently holding oversight hearings which may lead to major legislative changes in our present financial system. However, whatever legislation Congress decides to enact in this area will be difficult to implement if federal agencies succeed in effecting revolutionary changes in the financial marketplace through administrative actions. Moreover, careful Congressional deliberation will undoubtedly be prejudiced by such events.

In light of these considerations, the Institute's Board of Governors has unanimously endorsed the enactment of a fair, balanced moratorium affecting all segments of the financial services industry in order to provide time for rational decision-making by the Congress.

We hope you agree that the enactment of such a moratorium would assure that it will be the Congress which determines the major public policy issues involved.

Sincerely,

David Silver

NATIONAL ASSOCIATION of
CASUALTY & SURETY AGENTS

Government Affairs Office
600 Pennsylvania Avenue, S.E.
Suite 211
Washington, D.C. 20003
(202) 547-6616

June 14, 1983

The Honorable H. John Heinz III
Russell Office Building, Room 469
United States Senate
Washington, DC 20510

Dear Senator Heinz:

On behalf of the National Association of Casualty and Surety Agents (NACSA), an association representing the leading domestic, commercial property/casualty insurance agencies and brokerage firms, I want to confirm our unequivocal support for the moratorium drafted by the Federal Reserve Board on May 24, 1983.

We believe a moratorium is necessary in order to preserve the safety and soundness of our dual banking system and to preserve fair competition in the financial services marketplace. Once enacted, the moratorium will allow the Congress to decide what the appropriate structure should be for financial services.

We appreciate your interest and commitment to this important measure, and we offer you our continued support.

Sincerely,

Joan Albert Dreux

Joan Albert Dreux
Government Affairs Director

JAD:jb

Casualty/Surety/Fire/Marine
1913-OUR SEVENTIETH YEAR-1983

THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS
WASHINGTON, D.C.

OFFICE OF THE
PRESIDENT

June 14, 1983

The Honorable John Heinz
United States Senate
277 Russell Building
Washington, D.C. 20510

Dear Senator Heinz:

I understand that you will soon introduce legislation to impose a comprehensive moratorium on the expansion into the banking and thrift industry by non-depository institutions and to prohibit state-chartered institutions from engaging in activities other than those that are permissible under Section 4 of the Bank Holding Company Act. The National Association of Life Underwriters endorses this moratorium and appreciates your efforts on this issue.

The National Association of Life Underwriters is a federation of over 1,000 state and local associations representing over 125,000 life and health insurance agents, general agents and managers doing business in virtually every city and town in the United States.

By the passage of Title VI of P.L.97-320, the Garn-St Germain Depository Institutions Act of 1982, Congress reaffirmed the long-standing public policy first enunciated in the National Banking Act of 1864 that has separated banking from commerce.

NALU believes that passage of Title VI was a victory for consumers and will help to preserve an open, competitive marketplace by preventing bank holding companies and their subsidiaries from using their power to grant (or withhold) credit to pressure the consumer to purchase insurance. While not always explicit, the pressure to purchase insurance (the subtle tie-in sale) may be a mere perception of the buyer that it would be to his "advantage" to make the joint purchases. Title VI will allow consumers to purchase insurance which has the best terms, quality and services, not due to a need to obtain, or a fear of losing, a line of credit.

However, on March 4, 1983, less than six months after passage of Title VI, under pressure from several large bank holding companies hoping to circumvent Title VI, South Dakota adopted legislation (promoted as an "emergency" jobs bill) authorizing its state banks to engage, directly or through subsidiaries, in all facets of the insurance business. The South Dakota legislation was deliberately designed to attract out-of-state bank holding companies interested in acquiring a state-chartered bank for the purpose of underwriting and selling insurance nationwide. Delaware is also considering legislation similar to the law adopted by South Dakota.

The bankers argue that in order to remain competitive, they must be permitted to offer an entire array of financial services, including insurance. NALU stated in its testimony before the Senate Banking Committee on June 7, 1983 that the so-called "level playing field" could not be even bulldozed into playing condition where banks are the competitors. Free market discipline cannot take place so long as banks can attract federally-insured deposits and are not permitted to fail. It has been well documented that the unique power of the banks to extend or withhold credit leads consumers to purchase insurance offered by the bank, not because it has the best terms, quality or service, but so as not to jeopardize a line of credit.

The power of state legislatures to authorize expanded insurance activities within their borders is not at issue. Bank holding companies are deliberately attempting to engage in activities through state banking subsidiaries which are prohibited to bank holding companies and their non-banking subsidiaries under federal law. The South Dakota law demonstrates that the action of one state can potentially nullify federal banking laws and the related regulatory structure.

The proposed moratorium, in our view, will provide Congress with the opportunity to decide the future course of financial institutions in an orderly fashion, taking into consideration the public interest. NALU believes that a moratorium will provide the depositor with stability and freedom of choice. Bank involvement in insurance or securities activities subjects the depositor, the FDIC and FSLIC and, ultimately, the U.S. taxpayer to unknown risks.

Again, we thank you for introducing this legislation. Please contact David A. Winston at (202)331-6054 if we can provide you with any further information.

Sincerely,

Rice E. Brown

Rice E. Brown, CLU

PROFESSIONAL INSURANCE AGENTS
GOVERNMENT AFFAIRS OFFICE
600 PENNSYLVANIA AVE. S.E. SUITE 203, WASHINGTON, D.C. 20003
(202) 544-8713

14 June 1983

The Honorable H. John Heinz, III
United States Senate
277 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Heinz:

The National Association of Professional Insurance Agents (PIA) is a trade association representing more than 40,000 independent property and casualty insurance agents in all 50 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands.

PIA believes that recent efforts in the rapidly evolving financial services marketplace may well result in dismantling, as a practical matter, of the federal regulation of depository institutions by the enactment of state laws, and regulatory fiat. This situation is inconsistent with the long-standing national policy of protecting the depositing public, and the soundness of banks and thrifts by careful regulation and statutory restrictions upon the commercial activities in which depository institutions may engage. It is therefore imperative that this situation must promptly be reviewed by the Senate Committee on Banking, Housing, and Urban Affairs to protect the public interest.

The Federal Reserve System (Fed) has proposed moratorium legislation that would bring to a temporary halt efforts by financial institutions that are designed to evade the impact of federal banking laws. During the moratorium, all interested parties would have an opportunity to advocate their position before the Committee. This will provide the Congress with an opportunity to consider these controversial issues in a careful and reasoned manner and propose appropriate remedial legislation. A copy of the Fed draft bill, dated May 24, 1983, was attached to PIA's statement submitted to the Committee for the June 7 Oversight Hearing.

A NATIONAL ASSOCIATION . . . PROTECTING YOUR FUTURE

PIA strongly supports this moratorium legislation and urges you to sponsor it as soon as possible.

Sincerely,

Edward H Akin

Edward H. Akin, CPCU
President

J. Knox Hillman Jr.

J. Knox Hillman, Jr.
Chairman, Federal/State
Affairs Committee

SIA
SECURITIES INDUSTRY ASSOCIATION
120 Broadway, New York, N.Y. 10271 · (212) 425-2700

June 14, 1983

The Honorable John Heinz
United States Senate
277 Russell Senate Office Building
Washington, DC 20515

Dear Senator Heinz:

Thursday, June 16, 1983, marks the Fiftieth Anniversary of an event of singular and continuing significance for our financial system, the signing of the Glass-Steagall Act. It also marks SIA's appearance before you, as a Member of the Senate Banking Committee, to discuss the current problems facing the financial services industry about which we are concerned.

We are encouraged especially, Senator Heinz, that your approach to the issues at hand may include an affirmative legislative proposal designed to give the Congress, the Administration and the marketplace time and occasion to make decisions without panicked haste.

The rapid pace and happenstancial character of recent structural changes affecting the financial services markets cause great apprehension to the members of the securities industry that small regard is being given to the potential adverse consequences of unchecked deregulatory actions by some Federal and State officials.

Confusion, frustration, and uncertainty have resulted from recent decisions and proposals by the governmental entities responsible for clarity, assurance, and certainty among institutions comprising the financial sector of our economy.

Above all, we fear that the control and direction of an important national public policy has been usurped from the Congress by appointees in Federal agencies and a few State legislatures.

Despite the cries of changing technology and sophisticated consumer demands, the real pressure for change comes from a handful of institutions intent upon chartering a new course for all. When friendly regulators competing for favor among the regulated void our national policy separating commercial banking from commerce, the time for Congressional action is upon us.

WASHINGTON OFFICE 490 L'Enfant Plaza East S.W. Washington, D.C. 20024 · (202) 458-4664

During the next few weeks, the Senate Banking Committee and the Congress will have to define short-term and long-term objectives for the financial services industry. This would best be done without the pressures created by a rapidly moving marketplace, and even more rapidly moving bank regulators. Given these circumstances SIA has, after much discussion, decided to support a moratorium to create the needed breathing room. This moratorium must be evenhanded, reciprocal, and affecting all industries equally. All segments of the financial services industry must be made to mark time while critical long-term policies are defined by the Congress.

We look forward to testifying before the Senate Banking Committee on Thursday to further amplify our support for such a course of action. We hope that you can agree that such an interim measure has merit as well as necessity. Our pledge of cooperative effort with you and your staff extends to others interested in prudence and stability as goals of a changing economic environment.

Very truly yours,

Robert E Linton

Edward

Robert E. Linton
Chairman

Edward I. O'Brien
President

Senator **Heinz**. I want to thank our distinguished panel for their patience in putting up with me, and according to my witness list, our first member of the panel to testify will be Robert E. Linton.

Mr. Linton.

STATEMENT OF ROBERT E. LINTON, CHAIRMAN OF THE BOARD, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF DREXEL, BURNHAM, LAMBERT, INC., CHAIRMAN OF THE BOARD, SECURITIES INDUSTRY ASSOCIATION, ACCOMPANIED BY EDWARD I. O'BRIEN, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. **Linton**. Thank you.

In case you have a problem following my dulcet tones.

Thank you, Mr. Chairman.

We will exercise all the patience necessary to hear remarks such as those you have just made, with which we agree heartily.

I am Robert E. Linton, this year's Chairman of the Securities Industry Association, the group representing the vast majority of the Nation's security firms. I am Chairman and Chief Executive Officer of Drexel, Burnham, Lambert, Inc., the industry's 12th largest firm.

This is my 38th year in Wall Street, during which time I have been active in all phases of the industry. These years have all been spent with Burnham & Co. and its successors, one of our Nation's premier international investment organizations.

With me on my right is Edward I. O'Brien, president of the Securities Industry Association.

We have a written statement which we ask to be inserted in the record. It chronicles all the reasons for our being here and the frustrations which envelop both you and us, frustrations which are symptomatic of a grave concern that the legislative cornerstone of our financial and capital market structure, the Glass-Steagall Act, is rapidly being eroded by a series of heedless actions of Federal agencies and a few State legislatures.

Senator **Heinz**. Without objection, the entire statement will be part of the record.

Mr. **Linton**. Thank you.

We welcome this opportunity to appear before you to urge that Congress immediately enact a moratorium on further Federal agency and State legislative action so that it will have sufficient time to deal with the problems within the financial service industry presented by radical regulatory and State actions and proposals destructive of national policy as established by Congress.

HUMPTY-DUMPTY OF FINANCIAL SERVICES

The Humpty-Dumpty of financial services is teetering on the wall, with Chairman Isaac trying to push him over. Once he falls there will be no putting him back together again.

Therefore, we call on Congress to vote a moratorium and to use the time of a freeze at long last to examine and, if necessary, rewrite the Glass-Steagall Act, whose 50th anniversary we celebrate today.

We asked to testify on this day for a very, very special reason—50 years ago today President Roosevelt signed into law the first major legislation enacted by Congress designed to help get this country back on its financial feet—the Glass-Steagall Act.

In a real sense, that day also saw the birth of the modern securities industry. The Glass-Steagall Act, which separated commercial banking from investment banking and created the FDIC, the Securities Act of 1933, and the Securities and Exchange Act of 1934 have all had extraordinary vitality.

The framework Congress erected has served this nation very well indeed. The wise decision to create a protected commercial banking system separate from the entrepreneurial risk-taking characteristic of the securities business and to expose that high-risk business to the continuous light of day is something at which the world still marvels.

Our country has derived extraordinary benefits from that wisdom. Not only do we have the most open and dynamic capital markets in the world, but we have the greatest multiplicity of financial choice.

We owe that diversity of choice in very large part to the Glass-Steagall Act. So on this auspicious day we pay homage to those far-sighted creators of financial order, Senator Carter Glass and Congressman Henry Steagall, who probably did not know how well they built. May their spirit and their wisdom guide us for another 50 years.

Senator HEINZ. Mr. Linton, this may be a very appropriate place to interrupt. There are approximately 4 minutes left on a recorded vote which I must go and record my vote on. So I am going to recess the hearings until such time as Senator Hecht and myself or another member of the committee—well, that statement is inoperative. [Laughter.]

Mr. LINTON. Thank you, Senator Heinz. We hope you are coming back.

Senator HEINZ. I intend to.

Senator HECHT [presiding]. The last vote, to keep you all up to date, was to raise the salaries to $80,000 a year. [Laughter.]

They tell me there's five more votes. We started at $100,000 and now it is $80,000. So we might end up being an eleemosynary group.

For those of you who never had eleemosynary business, that is when there is no profit. [Laughter.]

Mr. LINTON. I might interrupt, Senator Hecht, by saying that we abhor the underpayment of members of Congress [laughter] and think it is so out of line with the real world that we can't understand why it can't be adjusted to more modern standards.

CONFUSION DOMINATES FINANCIAL MARKETPLACE

I wish we had a vote. Unfortunately, confusion, not wisdom, dominates the financial marketplace today. Those fundamental principles put in place 50 years ago by Congress are being systematically undermined by Federal bank regulators and increasingly by state officials lured by the siren songs of big bank expansion, such as:

> What we at Bank X did for South Dakota is nothing compared with what we can do for Minnesota; get rid of your usury ceiling; drop your bank taxes; let us be

travel agents or sell real estate and insurance and you will have us forever, or until a better deal comes along.

Well, Minnesota didn't fall for it, but it looks as if others still may as the large bank holding companies continue to press on.

So where are we? Who is winning? There is no question about it, all of us are losing.

For years, SIA has appeared and testified before committees of Congress, making the same point: a piecemeal approach to changing the basic law separating commercial banking and investment banking will be dangerous to depositors and grossly unfair to our industry. Dangerous because pulling one string out of a ball of yarn might cause a lot of other strings to be unraveled that might not be good to have unraveled, and unfair because the string being principally tugged would give banks more power to invade our business with their tie-ins, tax advantages, and federally conferred privileges intact.

Fortunately, enough people, in Congress and elsewhere, have recognized that danger and that unfairness so that no piecemeal legislation has been passed at the Federal level. At a time when the banking industry is troubled by overextended commitments in its regular business and the Federal Reserve Board is requiring some of the largest bankholding companies to increase their capital, it does seem odd to us that allowing banks to enter other areas of commerce is even being discussed.

Safety in banking must still be the primary concern of all of us in order to avoid any more Penn Square disasters. SIA repeatedly, most recently in 1981 and 1982 before this committee and your securities subcommittee, urged Congress to begin grappling with the problems posed by our ever-changing financial marketplace. We pledged our full cooperation in working out a solution in the national interest.

It is a monumental task, no doubt about it, and the temptation to pick away at it is understandable but, with all due respect, wrong.

The immediate consequence of congressional inaction has been runaway Federal bank regulators, most noticeably the Comptroller of the Currency and the Federal Deposit Insurance Corporation. Even though Congress took note of the overreaching tendencies of the regulators, its admonition to them—specifically directed that the Federal Home Loan Bank Board—and the report accompanying the Garn-St Germain Act did not seem to have any effect.

BREATHTAKING CHANGE OF ESTABLISHED CONGRESSIONAL POLICY

What presents a more breathtaking change of established congressional policy than what Mr. Isaac has proposed is more than most bankers have dreamt of in their wildest moments?

We would like to focus on some fundamentals.

One, the separation of commercial banking from investment banking and the rest of commerce has been a good thing for the country. We all need and benefit from a safe and sound banking system.

Congress mandated the separation of commercial banking from the high risk, entrepreneurial nature of investment banking to promote sound, steady, clear-eyed lending practices and to avoid conflicts of interest that were impossible to regulate adequately.

It recognized the human tendencies which lead to tie-ins, conflicts of interest, self-dealing, and overreaching.

Congress was concerned about the concentration of financial and economic power in the banking industry. And saying that international lending today is riskier than underwriting corporate stock or revenue bonds—but what about WPPSS?—is not an argument for tearing down Glass-Steagall, but for saner foreign lending practices. Sweaty palms do not make for sound banking.

Two, the ingenuity of the legal fraternity has amply demonstrated that the Congresses of the early 1930's did not do their work with quite the precision that we are used to in today's Federal statutes. And when not only banks but empire-building bank regulators seek to find, exploit, and enlarge every ambiguity in a bank-favoring fashion, the policy wall of Glass-Steagall, erected to help establish a stable banking system, is being destroyed.

BANK REGULATORS UNDERMINING AND DESTROYING GLASS-STEAGALL

Make no mistake about it, Glass-Steagall is being undermined and destroyed by bank regulators. The Comptroller of the Currency can call a banana an apple, and the only recourse for the nondepository financial industry is to sue. How many suits can we or should we have to finance?

The Comptroller's stretching of the Glass-Steagall Act to fit virtually all bank requests led to a 1980 congressional enactment prohibiting the Comptroller from issuing rules and regulations with respect to the securities activities of national banks under the Glass-Steagall Act.

And now Mr. Isaac of the FDIC, shrugging aside 50 years of experience, says that Glass-Steagall policies do not extend to State banks which are not members of the Federal Reserve System, so it is all right for them to underwrite and sell corporate stock. And he suggests that banks can deal in highly speculative stocks, which are those usually sold on a "best efforts" basis.

Is that really good for the soundness of banking and public confidence in banks?

Never mind the impact on the capital-raising mechanisms of this country or the incentive provided for banks to bail out of the Federal Reserve System. And the Federal Home Loan Bank Board doesn't think that savings and loan associations should even bother with Glass-Steagall principles.

It does not make any sense for national banks and State banks which are members of the Fed to be the only ones subject to Glass-Steagall restraints on securities activities. Unfortunately, that fundamental policy logic doesn't seem to concern Federal bank regulators.

Did it occur to anybody in 1933 that S&L's might someday get commercial banking powers or become interested in engaging in stock or other securities activities?

What responsibility does that impose on the Federal Home Loan Bank Board? Why does the FDIC want to return to dangerous and discredited practices that were rife prior to 1933?

Isn't it clear that Congress in 1933 really expected to cover all banks involved in such activities? Some argue there is a hole in Glass-Steagall that daily, today, more and more people are trying to squeeze through, including, I should add, some of my more exasperated bretheren in the securities industry. And Federal bank regulators are busy widening the hole.

We now find that banks can own brokerage operations as long as they don't underwrite securities or give investment advice. What, pray tell, is Charles Schwab implying by offering commission-free purchases of stock in its parent, BankAmerica Corp.? And in South Dakota and elsewhere, the competition for looser regulation is reaching frenzied new heights. Really, now, should national policy be determined in Pierre and other State capitals?

Three, national financial policy should be set by Congress, and not abdicated to States or Federal bank regulators. Congress should move as expeditiously as it can to examine and, if necessary, reshape national financial policy. It should blow the whistle on all loopholes exploitation, and we mean both ways.

Of course, it will be inconvenient. Of course it can't be 100 percent fair, but it's a lot better than inviting market chaos by doing nothing.

To do nothing, in reality, is to act for the smell of blood is in the nostrils of those who want change, apparently regardless of the consequences of that change. Before this country goes too far down the path which it is opening up before us, we had better make sure, as a nation, that we want to go there.

Do we want the dramatic increase in concentration of financial resources that will inevitably result? Look at the systems which prevail among most of our international trading partners, where a handful of giant banking institutions dominate their economies. As a result, the raising of equity capital ranges from difficult to impossible in these countries.

Do we really want to seriously, and perhaps irreparably, damage the most vibrant and varied financial marketplace the world has ever seen? Are we convinced that conflict of interest, greed, self-dealing, overreaching, and the gambling instincts are human traits of the 1920's and 1930's that have been eliminated in this most enlightened decade? Do you know yet what is better for the soundness of our banking system, the safety of people's deposits, and the capital needs of our business? We sure don't, but the laissez-faire Federal bank regulators and Governors hungry for banking business have put us all on a slippery slope. So we ask Congress to get on with the full-scale probe of the difficult and complex questions involved in ordering the financial marketplace of the 1980's and beyond. This will probably take awhile even with the most optimistic timetable. SIA will cooperate in every way possible. We support the suggestion advanced by Chairman Volcker and a number of others for a moratorium. While Congress deliberates there must be an effective two-way plugging of all real or imagined Glass-Steagall loopholes extending to all banks, thrifts, and other depository institutions both State and Federal, as well as all others, including securities firms. The moratorium will give us time to get the job done. Clarifying the coverage of the Glass-Steagall prohibitions by explicitly defining them as including all financial institutions insured or eligible to be insured by the FDIC or FSLIC might be the simplest way of plugging the holes and affirming existing policy in embarking upon a moratorium. In no event should a moratorium be used as an excuse for doing nothing.

By design and good fortune, we have achieved in this country a financial system second to none. It works very well. Let us be careful with it. It is the only one we have.

The continuing need for a safe, sound, stable banking industry is of the utmost importance. We in the securities industry, however, recognize that advances in technology and communications and conditions in the world may require a reworking of yesterday's principles to fit the realities of today.

The public interest should guide our efforts in this endeavor. We are convinced that what is best for the country will work best for all of us.

We pledge, again, that we will work diligently and expeditiously with Congress to create the financial structure needed for this time and this place. We thank you for your attention.

[The complete statement follows:]

TESTIMONY OF THE SECURITIES INDUSTRY ASSOCIATION
ROBERT E. LINTON, CHAIRMAN OF THE BOARD OF DIRECTORS
ON THE ROLES OF INSTITUTIONS WITHIN THE FINANCIAL
SERVICES INDUSTRY BEFORE THE SENATE COMMITTEE ON BANKING,
HOUSING & URBAN AFFAIRS
JUNE 16, 1983

I. INTRODUCTION

The Securities Industry Association ("SIA") is a national trade association representing approximately 500 organizations responsible for over 90 percent of the securities brokerage and investment banking business of the nation. Our membership is a cross-section of firms involved in all facets of the securities business and encompasses members of national securities exchanges as well as firms which are not members of such exchanges. The business of our members includes retail and institutional brokerage, over-the-counter market-making, underwriting and other investment banking activities, and various exchange floor functions. Many of our members perform these services with regard to municipal and government, as well as corporate, securities. SIA member firms are located across the nation and provide services to investors of every description.

As the national trade group for the securities industry, we appreciate this opportunity to appear before the Banking Committee on the day which marks the fiftieth anniversary of an event of singular and continuing significance for our nation's financial system. On this day a half century ago, at a time when our financial system lay in near-total collapse and fully a quarter of our work force was unemployed, President Roosevelt put his signature on the Banking Act of 1933. Regrettably, the Banking Act did not immediately receive its full recognition because on the same day the President signed another measure, the National Industrial Recovery Act, which he termed "the most important and far-reaching legislation ever enacted by the American Congress." In the wake of such Presidential encomium for the NIRA, it is hardly surprising that in the New York Times of the next day the Banking Act attracted less prominence than the latest cure for the common cold. The Supreme Court, however, did not take long to dispose of the NIRA, which today is of little more than historical interest to constitutional scholars, and the common cold is still with us. The Banking Act, on the other hand, overcame its stepchild beginnings to become pivotal to the structure and soundness of our financial system. It remains so today.

The Banking Act had two crucial components, each of which has had profound effects on the banking system as it has since developed and each of which is receiving current scrutiny. First, through the creation of the Federal Deposit Insurance Corporation, it established the system of federal deposit insurance that has become a bedrock protection for bank depositors. Second, in four sections now commonly referred to as the Glass-Steagall Act,1/ it mandated the essential separation of the banking and securities industries so as to preclude a recurrence of the financial chaos and panic that precipitated its enactment. In our judgment, these principal features of the Banking Act of 1933 have contributed importantly to the soundness, stability and efficiency of our national financial system.

Today we are living in a period of dynamic and dramatic change in the financial services industry. Such recent phenomena as the emergence of money market mutual funds, the rapid dismantlement of deposit interest ceilings and combinations of non-bank financial institutions all bear witness to the truth of this broadly shared perception. Hardly a day passes when we are not solicited by one institution or another to make use of a new highly-touted service. In general, these changes speak well of the vitality of our financial system and of its ability to adapt to new realities and to meet the needs of consumers and investors alike.

Predictably, these new realities have produced a renewed chorus of calls from the banking industry for dismantlement of regulatory barriers that are depicted as straitjacketing the industry while non-bank financial institutions run roughshod over the bankers' turf. We have yet to hear our brethren in the banking industry call for abolition of federal deposit insurance as an unneeded anachronism,2/ they show no reluctance to point their fingers at the Glass-Steagall Act as an outmoded statute that can serve no useful purpose in the age of "financial supermarkets."

With today's rapid pace of change in the financial services industry, a pause to look over one's shoulder at events a half-century ago may seem like needless distraction from the work at hand. Yet, if one suspects there is little in our history relevant to an era of financial supermarkets, he may be surprised to learn that contemporary observers of the financial scene of the late 1920's referred to up-to-date banks as financial "department stores."3/ And before we too quickly assume that the concerns that prompted enactment of the Glass-Steagall restrictions have no application in today's circumstances, we would be well-advised to weigh carefully the recent observation of E. Gerald Corrigan, President of the Federal Reserve Bank of Minneapolis, that "(i)f anything, concerns regarding financial concentration, conflicts of interest, and fiduciary responsibilities associated with lending depositors' money may be more relevant today than they were fifty years ago."4/

Any scheme of restrictive regulation, including the Glass-Steagall Act, deserves revisiting periodically in light of current conditions. The SIA welcomes the ongoing Congressional review of the Glass-Steagall Act (as well as other laws and regulations that govern the banking and securities industries). At the same time, we are constrained to observe that in the current debate about deregulation of banking there too often seems to be an unqualified assumption that deregulation does not entail costs and inadequate recognition of the underlying reasons that explain our historic national policy of separating banking from other lines of commerce. The SIA does not advocate slavish adherence to the policies of the past. At the same time, we believe there is wisdom in Santayana's dictum that those who cannot remember history are doomed to repeat it.

Congressional concerns over the proper role of banks and bank holding companies have a long history dating to the mid-19th century. The first expression of national policy was the National Banking Act of 1864 which limited the powers of national banks to traditional banking functions.

The increasingly complex nature of our economy and the capital markets has required constant legislative change to maintain the effectiveness of the policy. For example, the speculative excesses of commercial banks during the 1920's and early 1930's led to enactment of the Banking Act of 1933 which was intended to prohibit banks from engaging in securities activities. In addition, the Bank Holding Company Act of 1956 5/ and the 1970 Amendments to that Act were, in part, Congress' response to attempts by the holding company affiliates of banks to engage in non-banking activities.

Despite the clear prohibitions of these statutes, commercial banks and their affiliates have engaged in an increasingly wide range of activities unrelated to banking activities, often with the sanction, and even the encouragement, of those banking agencies. SIA believes that unless the Congress acts quickly, the national policy to limit the non-banking activities of commercial banks will be largely eviscerated by regulatory action.

During recent years, the SIA's concerns have increased as bank regulators have embarked upon a path of ignoring a fundamental national policy. Never have so many agreed that bank regulators are unsurping Congressional prerogative. You, Mr. Chairman, noted it in your statement on the proposed rule of the Federal Deposit Insurance Corporation (FDIC) to permit state non-member bank underwriting activities. Mr. Shad, Chairman of the Securities and Exchange Commission (SEC), said to you last week in response to your question on the FDIC rule proposal, "I think that it does violence to the intent of the Glass-Steagall Act, and the concept of it." Congressman Wirth cited the problem in a recent speech 6/ when he stated, "More recently, we have seen a number of actions by bank regulators who, instead of rushing to plug the holes in Glass-Steagall, have hurried to approve activities which were previously believed to be barred by at least the spirit--if not the letter--of Glass-Steagall."

Just three years ago the Fed permitted commercial banks to underwrite, sell and distribute commercial paper.7/ One year ago, the Federal Home Loan Bank Board (FHLBB) permitted establishment of full service brokerage subsidiaries by Federal savings and loan associations, and the FDIC allowed the acquisition or establishment of firms engaged in full scale underwriting activities by state non-member banks. At about the same time, the Fed and the Comptroller of the Currency approved discount brokerage for member banks and their affiliated holding companies. A month ago, the FDIC proposed another direct affront to the national policy embodied in the Glass-Steagall Act by announcing a rule permitting state non-member banks to be affiliated with or to own a broker/dealer that underwrites, sells and distributes securities (including debt, equity and mutual fund shares) to the public. All of this has happened without any new Congressional direction or modification of our longstanding national policy.

The pressures for change essentially are not different today than they were fifty years ago, and they are driven not by advances in technology, consumer demand or innovation, but rather by the desire of a small number of large money center banks to be the financial supermarkets. These gigantic institutions want to provide computer terminals in customers' homes to take deposits, pay bills, buy and sell stocks and bonds, purchase insurance, and even shop for food and clothing. These giants also want to provide data-processing services, offer communications via microwave broadcasting, publish books, operate travel agencies and even provide hotel and conference facilities and, as Citicorp's lobbyist noted, when they don't like their environment they will change it.8/

In view of the evidence that the Federal banking regulators are choosing to ignore the national policy to limit the securities activities of banks, the need for immediate action is apparent.

II. CONGRESSIONAL POLICY REGARDING NON-BANKING ACTIVITIES OF BANKS AND BANK HOLDING COMPANIES

Since enacting the National Bank Act of 1864, Congress repeatedly has expressed its determination that the public policy of the United States must be to separate the business of commercial banking from unrelated areas of economic or commercial activity. In fact, the history of federal regulation of the banking industry largely has been an effort to restrain the domination of commercial banks over non-banking sectors of the economy. Why? Because of the central role banks play in our economy and the benefits and privileges granted to them in recognition of the role.

In 1933, Congress recognized the dangerous involvement of commercial banks in non-banking fields, particularly in the securities industry, and decisively moved to terminate such activities. In enacting the Glass-Steagall Act, Congress prohibited banks from entering the securities field as well as other non-banking areas. It enumerated the direct powers of national banks in Section 16 of that Act and described certain limited incidental powers that would be permitted in order that the business of banking be efficiently conducted.9/

The Act further prohibited an entity that issues, underwrites, sells or distributes securities from engaging in the banking business and forbade member banks of the Federal Reserve System from being affiliated with securities firms, either directly or through interlocking directorships.

The hearings that preceded Congressional enactment of the Glass-Steagall Act led to the finding that "commercial banks in general and member banks of the Federal Reserve System in particular had both aggravated and been damaged by the stock market decline partly because of direct and indirect involvement in the trading and ownership of speculative securities."10/ As viewed by the Supreme Court in ICI v. Camp, the Glass-Steagall Act reflected a "determination that policies of competition, convenience, or expertise which might otherwise support the entry of commercial banks into the investment banking business were outweighed by the 'hazards' and 'financial dangers'" that arise when commercial banks engage in such activities proscribed by the Act as general securities trading.11/

As a result of the continuing movement of banks into securities and other non-banking fields, later Congresses indeed found it necessary to reinvolve themselves with this issue and further to restrict extra-banking activity. The Glass-Steagall Act applied to bank holding companies only if the subsidiary bank was a member of the Federal Reserve System and the holding company sought to exercise control over a non-banking affiliate by actually voting its shares. This limitation became a major loophole by which holding companies acquired a wide variety of non-banking subsidiaries. In enacting the Bank Holding Company Act of 1956, Congress sought to close this loophole by specifically requiring bank holding companies to divest themselves of all non-banking business, with an exception only for activities so closely related to the business of banking to be a proper incident thereto.

The exemption permitted by the 1956 Act for bank affiliates engaged in activities "closely related to the business of banking," clearly was intended to be a narrow one. Examples provided by Congress of activities falling within this exception were precisely circumscribed and did not include any activities related to the securities industry. For example, the Senate Report noted that such bank-related activities as "a credit life insurance program or a mortgage insurance program in connection with bank loans" would be of the type contemplated by the exemption from the rule.12/

Despite the 1956 Act, many banks sought to devise means to circumvent the clear intent of the law and acquire non-banking businesses through the vehicle of one-bank holding companies, a concept not contemplated by the 1956 Act. Through this new loophole, substantial money center banks engaged in vigorous acquisition programs and entered a wide variety of unrelated lines of commerce.

Congress acted quickly to curb this renewed attempt by banks to dominate non-banking fields by enacting the Bank Holding Company Act Amendments of 1970, which specifically prevented one-bank holding companies from entering businesses unrelated to traditional banking.13/ As a result of considerable controversy within Congress over the types of bank-related business ventures in which banks should be permitted to engage, the final language of the 1970 Amendments represents a compromise that has proven troublesome for courts and regulators to administer. Nevertheless, it is clear from the following Senate floor colloquy during action on the amendments, the Congress was careful to avoid any narrowing of the restrictions of the Glass-Steagall Act.

> Mr. Williams of New Jersey:...I wonder whether there was any intention to imply that the very securities-related activities forbidden to banks directly may nevertheless be engaged in by bank-holding companies or their non-banking affiliates.
>
> Mr. Sparkman: The answer to the Senator's question is that there clearly was not.14/

Since being granted this discretionary power, the Federal Reserve Board has determined that a number of activities, though beyond traditional banking functions, are "so closely related to banking or managing or controlling banks as to be a proper incident thereto" and it has permitted bank holding companies to perform them. The latest interpretation by the Fed was to permit the BankAmerica Corporation, the holding company for the largest U.S. bank, to acquire Charles Schwab & Co., Inc., the largest discount broker.

The picture that emerges is that of Congress, on the one hand, continually seeking to keep banks focused on their primary functions accepting deposits, and making loans, and the banks, on the other hand, relentlessly pursuing loopholes and other means of sidestepping Congress' restrictions, largely unimpeded by their regulators.

III. CURRENT EXPANSION OF SECURITIES ACTIVITIES OF COMMERCIAL BANKS

For almost a decade, bank regulators have been promoting new securities activities for banks. The regulators have purposefully dismantled the prohibitions in the Glass-Steagall Act to prevent the combination of deposit taking and commercial lending with underwriting, selling and distributing securities. The balance of this section examines these regulatory departure from national policy.

Underwriting and Principal Activities

After both the Comptroller of the Currency ("OCC") limited private placement activities of national banks in interpretive letters, and the Federal Reserve Board, prohibited private placement activities for subsidiaries of bank holding companies,15/ the Fed, in an abrupt about face, concluded that large commercial banks could legally provide private placement services.16/ It did so after strong pressure from commercial bankers. Less than one year later Bankers Trust Company began to underwrite and distribute commercial paper.17/ A ruling by the Federal Reserve Board that this activity does not violate the Glass-Steagall Act is still under judicial review.

The never-ending quest of banks to expand in municipal securities underwriting finds them constantly presenting municipal offerings for OCC approval. The Comptroller usually obliges by an expansive interpretation of the law to cover the request.

Last year by issuing a policy statement, the FDIC permitted a state non-member bank to organize a mutual fund complex to underwrite and distribute a group of mutual funds.18/ More recently on May 17, 1983, the FDIC published a proposed set of rules to permit state non-member banks to be affiliated with full service broker/dealers and to establish a subsidiary to underwrite corporate equity on a "best efforts basis", to underwrite top rated corporate and municipal debt, and to underwrite and distribute money market mutual funds. If this proposal were to become effective, what would be left of the Glass-Steagall Act? Assuming banks were willing to forego national charters and Federal Reserve System membership, it would be only a matter of time until the national policy embodied in Glass-Steagall was effectively voided by regulatory action.

This Spring, the major money center banks and bank holding companies mounted a unified, well organized campaign, on a state by state basis, to expand the powers of state chartered banks to underwrite, sell and distribute all forms of securities and debt. These institutions believe they have found a way to "backdoor" the Glass-Steagall Act and the Bank Holding Company Act.

Agency Transactions

The first assault occurred in the early 1970's, when the OCC issued several rulings permitting national banks to offer so-called "automatic investment services," another form of agency brokerage. By 1976, Chemical Bank introduced a retail brokerage service, offering execution of orders in listed securities and portfolio valuation services.19/

Events remained relatively quiet until the FHLBB authorized Federal savings and loan associations to enter the brokerage business through the use of a service corporation affiliate about a year ago. This third-tier service corporation was permitted to execute agency trades on behalf of customers, while rendering investment advice.20/ The case testing the legality of this plan is awaiting decisions in the Federal District Court for the District of Columbia.21/

The FHLBB action was quickly followed by the OCC granting permission for national banks to enter by acquisition or by de novo entry the discount brokerage business.22/ This action is also in litigation.23/ Moreover, the OCC is currently considering the expansion of this activity to include the giving of advice in conjunction with the agency execution. Additionally, the OCC is considering an application by a commercial bank to acquire brokers' brokers in both corporate and municipal debt.24/

In the midst of these actions, the Fed determined on January 24, 1983, that discount brokerage was so closely related to the business of banking as to be a proper incident thereto, when it approved the acquisition of Charles Schwab & Co., Inc., by BankAmerica Corporation.25 Once again, the issue is before the courts.26/

Last, but not least, is the FDIC General Counsel Opinion #6, 27/ permitting state non-member banks to engage in discount brokerage activities through a non-affiliated broker.

All of the above regulatory change has taken place without Congressional sanction.

IV. PUBLIC POLICY REASONS REQUIRING AN UNEQUIVOCAL CONGRESSIONAL REAFFIRMATION OF NATIONAL POLICY ON BANKING

Maintaining an Efficient and Respected Financial System

The national policy of this country to date has been to foster a diversity of financial institutions providing a wide range of products to meet the needs of both investors and consumers. The Glass-Steagall Act separates commercial banking and investment banking. The Home Owner's Loan Act created federally chartered thrift institutions to encourage thrift and home ownership. Credit unions were established by national legislation to promote self-help membership corporations focused on consumer lending, while federal legislation left the development of regulation of the insurance industry to 50 state regulators. The dual Federal and State system for both commercial banks and thrift institutions has created a diversity within those industries.

This diversity has produced healthy inter-industry competition which has served the consumer well. On the corporate front, it has resulted in the commercial paper market as an alternative for short-term bank loans. On the individual front, it has given the small investor the benefit of market interest rates previously enjoyed only by the wealthy individual or large institutions.

One country where this kind of diverity is lacking is West Germany. In West Germany a handful of gigantic banks control all financial services, and its tax system discriminates against equity. Incestuous relationships develop between corporated borrowers and their banks. There is an acknowledged lack of financing for small and developing businesses. This particular problem was noted only recently in an article in the New York Times on June 6, 1983. The article, "West German Venture Capital," told of a small Germain high-tech business that was forced to raise equity capital in the United States. Finally, real conflicts of interest have developed because of the common ownership of lending and underwriting corporations.29/

Bank Stability

Perhaps the most significant aspect of our national policy regarding banks has been to promote a safe, sound, stable banking system. There are three primary requisites to a stable banking system that currently are threatened as banks are permitted to become extensively involved in securities activities: (1) the efficient processing of prudent and disinterested loans and investments; (2) the maintenance of a relatively stable flow of revenue; and (3) the continued confidence of depositors.

The critical ability of banks to make loan and investment decisions solely on the basis of the financial prufence of each transaction is severely compromised when banks also engage in securities-related ventures.29/ As an example, at the height of activity of the REIT industry, it was a common bank practice to extend loans to a REIT to which the bank or its affiliate was providing investment advisory services and sponsorship. Although the amount of such loans has declined significantly with the general decline in REITs, these loans illustrate the dangerous temptations to which banks may succumb in promoting securities services.

The second key element of bank stability is a steady source of revenue. The commissions and underwriting revenues earned by securities brokers are inherently volatile. In addition, although banks now are permitted to underwrite general obligation bonds because there were felt to be relatively few risks involved in this practice, even this area of the securities industry entails significant risks for banks. Shortly before its demise, the Franklin National Bank lost $5.6 million in the value of securities which had been carried in the bank's security trading account or its bond dealer operations.

Moreover, because banks and brokers appear to be similarly affected by the business cycle, greater participation in the securities business would tend to accentuate fluctuations in a bank's income from its banking business. These fluctuations in bank earnings erode public confidence which in turn undermines the system.

Banks currently trade on a principal basis Federal Government municipal and certain exempt securities eligible for bank underwriting. It is illogical to assume that a bank will not trade on a principal basis all securities they may underwrite including corporate equity, corporate debt, and all municipal debt once permitted by regulation. This trend would expose banks to an entire new level of risk entirely inconsistent with traditional notions of safety and soundness.

A third element of bank stability is depositor confidence, which may be affected adversely by concerns over non-performing loans to foreign countries 30/, domestic energy companies 31, government securities dealers 32/ and in promoting a variety of investment vehicles that traditionally have been the province of securities firms. For example, if banks promote mutual funds, REITs or commercial paper issues which fail to meet investor expectations--which is not an unlikely possibility since such investments certainly are not risk-free--the image of banks as riskless, deposit-accepting institutions may be irreparably tarnished in the minds of the public.33/ Any serious loss of public confidence quite conceivably could lead to major withdrawals of corporate and personal bank deposits, the consequent diminution of the funds available for credit, and the possibility of bank failures. Situations developed in Oklahoma last year, and in Tennessee and Washington this year, where serious loss of public confidence created "bank runs."

Finally, in this era of deregulation it must be noted that banks and bank holding companies will never be subjected to the ultimate market discipline--bankruptcy, nor would SIA suggest that they should. Depositors' funds must be protected by insurance, and banks by the Fed's ability to be a lender of last resort, but in exchange for this ultimate protection, these institutions must be prohibited from accepting non-banking risks. To do otherwise would be to deal irresponsibly with tax payers' money. In this regard, it is interesting to note that the FDIC liquidated 42 banks in 1982 and 24 through June 1, 1983.34/

Avoiding Conflicts of Interest

A bank's performance of various securities services may create conflicts of interest adverse to its trust customers and other managed accounts, to its commercial customers, and to users of its securities services.35/ Although most trust departments undoubtedly strive to conduct their businesses in full compliance with the high standards imposed by fiduciary law, serious conflicts can lead to unconsciously distorted judgments. A bank's trust department, for example, might be inclined to purchase for its accounts securities which are the subject of a private placement arranged by the bank for a corporate customer or, in the case of municipal bonds, distributed by the bank as an underwriter.

Also, should an issuer for whom a bank has effected a private placement find itself in unexpected financial difficulty, the bank may feel obliged to extend a loan which might not otherwise conform to its normal credit standards. It understandably would seek to avoid possible embarrassment and damage to its reputation among the institutions which had purchased in the private placement or the possibility of threatened litigation by the purchasers under the securities laws.

In addition, the confidential financial information a bank frequently requests in connection with its commercial lending functions may be disclosed to its affiliated investment advisor or broker and may influence the bank in providing investment banking or brokerage advice to other customers. Such a potential conflict is apparent in cases where the financing for a cash tender offer is arranged by the same bank that serves as lender to the target company.36/

In the area of municipal bonds, commercial banks seem to have an exceedingly difficult time handling the multitude of roles that they concurrently perform for municipal issuers. Those roles are underwriter to the municipality, depository of its funds, investor in its securities, trustee of its bond and note issues, lender to the municipality and, lastly, its financial adviser. The combination of all of these activities in one institution creates a situation where the potential conflicts cannot be resolved, for when the bank must act in order to protect its depositors, it may not be acting in the best interest of its municipal client.

Avoiding Tie-Ins

The tie-ins which may occur when banks are involved in the marketing of securities services derive from the ability of commercial banks to extend credit. These tie-ins may be explicit (which probably is illegal) or implicit, but in either case they involve the linkage of bank credit facilities with securities services. The opportunity for implicit tie-ins, which can be most insidious, was discussed and illustrated by Richard W. McLaren, then Assistant Attorney General in charge of this Antitrust Division, in testimony before this Committee when it was considering the 1970 one-bank holding company legislation:

> "(T)here are dangers which are of a more structural nature--adverse competitive effects that would tend to develop naturally without actual overt use of the economic power carried over from the banking sphere.
>
> I refer to a voluntary form of reciprocity or tie-in effect, where a potential borrower may independently decide that, just because he might possibly be under watch, it is in his best interest to patronize bank-affiliated enterprises in the hope of improving his chances of obtaining credit from the bank on favorable terms, or indeed at all.
>
> This can be illustrated by an example. A potential loan applicant might voluntarily place his casualty insurance business with a bank-affiliated insurer in hopes of improving his chances for a mortgage loan on the insured property on favorable terms. This would have the same effect as a coercive tie-in. Competition in the tied product, insurance, would be lessened to the extent that customers no longer purchased it entirely on its own economic merit. One such merger might well trigger others and, as a pattern of such bank-insurance affiliations developed, market foreclosure in the tied field would become more and more serious.
>
> Such voluntary tying or tying effect, as we called it in a recent case, is the product of market structure--not misconduct.
>
> This structural problem is intensified because present antitrust remedies appear inadequate to deal directly with it. There simply is no illegal practice or conduct for a court to enjoin. Hence, we must concentrate on avoiding a structure which gives rise to such effects."37/

Aside from structural tie-ins, more explicit tie-ins often exist. In some such instances, a bank may condition the availability of its credit facilities on an issuer's patronage of the bank's private placement or commercial paper service. For example, most commercial paper is backed by a bank line of credit. This gives banks the opportunity to tie the availability of a credit line to use of the bank as distributor of commercial paper for the issuer.

Avoiding Unfair Competition

Congress long has recognized that it may be unfair to permit banks to compete against non-banks in the provision of non-banking services. In the context of bank securities activities, banks not only have access to funds at lower costs than non-banks; they are free from the costly regulation that burdens members of the securities industry. They also have the opportunity to tie the granting of credit to their securities services and otherwise to use their lending relationship to gain additional business. The special benefits accorded to banks to reduce the cost of intermediation reflect a valid national policy, but to permit their importation to other arenas of competition is not what Congress intended and is not sound public policy.

Bank Cost Advantages

The primary cost advantage enjoyed by banks over non-banks is the availability of low-cost funds. For example, federal deposit insurance serves to lower the rates of return required to attract depositors by making bank deposits up to prescribed levels virtually "risk-free." Such rates of return also may be kept artificially low through governmental action when legal interest ceilings on designated deposit and transaction accounts are at rates other than market forces would dictate.

In addition, banks have ready access to short-term capital at low cost through the federal funds market and the Fed's discount window. The cost to banks of long-term capital also is lower because of reduced investment risks associated with the banking business. Such reductions in risk result in part from federal and state restrictions on entry into banking and the readiness of the Fed to provide low-cost credit through the discount window to meet banks' temporary liquidity problems.

It would be patently unfair if non-banking entities were forced to compete with banks in any line of commerce without the benefit of these privileges.

Bank Tax Advantages

Banks may deduct interest expense in purchasing tax-exempt securities while enjoying the benefits of tax-exempt income. This treatment is denied all other investors, including broker/dealers. While various claims have been made as to the magnitude of this benefit, a statement by Larry F. Clyde during debate on this subject last year, indicated it could be as large as $1 billion.38/ Banks are permitted a deduction for partially worthless securities,39/ and may establish reserves for bad debts on the basis of a percentage of eligible loans rather than actual experience. 40/

Additionally, there are significant differences between the effective tax rates of the securities industry and commercial banks, as the following table demonstrates:

Effective Tax Rates

	1975	1976	1977	1978	1979	1980	1981	1982
Securities Industry	51.3	48.7	42.7	43.6	42.2	46.9	43.3	44.3
Commercial Banks	20.0	23.1	24.5	27.6	26.5	25.7	22.9	NA

Source: Lipper Analytical Distributors: Federal Deposit Insurance Corporation

Regulatory Advantages

Banks are not subject to the strict regulation of securities activities to which securities firms are subject, which adds to the operating costs and otherwise burdens the day-to-day functioning of members of the securities industry. As a result, investors may be afforded less protection. The extent of the safeguarding of investor funds is lessened, as the high standards of broker/dealer accountability set by the Securities and Exchange Commission have no coercive impact on bank activities.

Section 3(a)(4) of the Securities Exchange Act defines the term "broker" to mean "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." (Emphasis added.) This statutory exclusion was based on the Congressional understanding that banks were prohibited from engaging in the business of dealing in securities under the Glass-Steagall Act. Those who are classified as "brokers" under the Securities Exchange Act are required to conform to a comprehensive system of governmental and private regulation developed over the years for the protection of investors. Among the standards and safeguards provided under this system, but inapplicable to banks and thus unavailable to their brokerage customers, are those relating to advertising, broker training, suitability, prompt and best execution, prompt delivery of securities and confirmations with regard to each transaction, disclosure of adverse information, and insurance under the Securities Investor Protection Act.

Bank regulators permit banks to carry municipal bonds at cost rather than marking them to the market on a daily basis as required for broker/dealers. A loss is only realized upon sale. Non-performing loans are not marked to the market, and special accounting rules have been developed for recognizing fees paid upon renegotiation. Bank regulators permit a greater degree of leverage for banks than the current net capital rules permit broker/dealers. Banks are permitted significant off-book liabilities such as letters of credits, not permitted other industries.

Taken together, these advantages make head-to-head competition between banks and other financial institutions a good deal less then equal.

V. THE PRESENT NEED FOR ADDITIONAL CONGRESSIONAL DIRECTION

The national policy set by both the Glass-Steagall Act and the Bank Holding Company Act is being disregarded by regulators under the perceived pressures of the moment. During the first 50 years of the Glass-Steagall Act many things have changed, but human nature has not. Consequently, additional legislative direction is needed that explicitly describes what, if any, securities activities are proper for deposit taking institutions and their affiliates.

As discussed earlier, the prohibitions on bank securities activities contained in the Glass-Steagall Act and the Bank Holding Company Act are clear, but federal banking regulators apply those prohibitions quite "flexibly." Further exacerbating the problem is the informal nature of the review of bank securities by the federal banking regulators.41/

Clearly, then, if our national policy to restrict the non-banking activities of banks, thrifts and their holding company affiliates is to have any effect, Congress must act now to reaffirm that policy. It may do so by unambiguously closing perceived loopholes, or, since time is short, an effective reciprocal moratorium could be enacted to permit sufficient time for Congress to address these issues. SIA endorses a moratorium in order to re-establish Congressional control of national policy, to debate what (if any) changes are necessary, to study how our capital markets will be affected, and to determine how financial services delivery systems are to be organized.

The tasks for Congress are difficult, and the longer they are unaddressed, the greater the market place pressure for change. SIA suggests at least five problems to be resolved: First, what are the respective roles of financial institutions in today's market, and how should they evolve?42/ Second, what role should banks play in the U.S. economy, and how do we protect deposits? Third, should our national policy separating banking and commerce change? Fourth, what impacts will changes in the current environment of the financial services industry have on the U.S. capital markets?43/ And lastly, ill the U.S. Treasury proposal for a separate subsidiary structure to deregulate bank holding companies work?44/ Some work to answer these questions has been done; much remains.

Lastly, SIA would like to note a related area which needs to be examined by the Congress. Should the exemptions banks enjoy from the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act and the Investment Advisers Act be eliminated? Functional regulation may be the only way to solve certain competitive imbalances and to rationalize our financial system in the eyes of consumers.

* * *

The financial services industry is at a cross road. Basic choices must be made by the industries affected, and the direction must be set by Congress. Congress must revisit our current national policies and either change them or reaffirm them, so all may plan for the future.

We appreciate having this opportunity to express our views. We will be happy to respond to any questions which the subcommittee may have at this time or which it may have subsequent to these hearings.

FOOTNOTES

1/ These sections are now codified at 12 U.S.C. § § 24 (Seventh), 78, 377, and 378.

2/ Interestingly, at the time of Congressional consideration of the Banking Act of 1933, the President of the American Bankers Association led industry opposition to the idea of federal deposit insurance as "unsound, unscientific, unjust and dangerous." Arthur M. Schlesinger, Jr., The Coming of the New Deal (Boston: Houghton Mifflin Company, 1959), p. 443.

3/ See, e.g., George W. Dowrie, American Monetary and Banking Policies (New York: Longmans Green, 1930), p. 25.

4/ E. Gerald Corrigan, "Are Banks Special?", appearing in Annual Report 1982 of the Federal Reserve Bank of Minneapolis, p. 13.

5/ 12 U.S.C. § 1841 et seq.

6/ Remarks of the Honorable Timothy E. Wirth, Securities Law Institute, University of Colorado, June 3, 1983.

7/ September 26, 1980 letter from the Board of Governors of the Federal Reserve System to John M. Liftin, Esq. and Harvey C. Pitt, Esq.

8/ "Inside Citicorp," New York Times magazine, May 29, 1983.

9/ Among those incidental powers is the ability to purchase and sell securities, but such authority expressly is limited to:

> purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the (bank) shall not underwrite any issue of securities or stock. 12 U.S.C. § 24 (Seventh).

10/ S.Rep. 77, 73rd Cong., 1st Sess., 6, 8, 10, cited in ICI v. Camp, 401 U.S. at 630.

11/ ICI v. Camp, 401 U.S. at 630.

12/ See, S.Rep. No. 1095, 84th Cong., 1st Sess. 13 (1955).

13/ See Board of Governors of the Federal Reserve System v. First Lincolnwood Corp. 439 U.S. 234, 99 S.Ct. 505, 512-13 (1978).

14/ 116 Cong. Rec. 42430 (1970).

15/ First Arabian Corporation 63 Fed. Res. Bull. 66 (1977).

16/ Federal Reserve Board, "Commercial Bank Private Placement Activities." (June 1977).

17/ See footnote 7.

18/ See policy statement, Board of Directors, Federal Deposit Insurance Corporation, August 23, 1982, (47 Fed. Reg. 38984).

19/ For a complete description of this plan, see The Wall Street Journal, September 17, 1976, p. 4; Securities Week, October 11, 1976, p. 1.

20/ Federal Home Loan Bank Board Resolution No. 82-327 dated May 6, 1982.

21/ SIA v. FHLBB, U.S. District Court for the District of Columbia Civil Action No. 82-1920-argued awaiting decision.

22/ Comptroller of the Currency approval of application of Security Pacific National Bank to establish a wholly-owned brokerage subsidiary dated August 26, 1982, and his approval of Union Planters National Bank acquisition of an existing broker/dealer dated September 20, 1982.

23/ SIA v. C.T. Conover, et al, pending U.S. District Court for the District of Columbia, Civil Action No. 82-2865.

24/ See applications to acquire an operating subsidiary filed by Security Pacific National Bank dated March 28, 1983.

25/ Order of the Board of Governors of the Federal Reserve System approving affiliation between a bank holding company and a public brokerage firm dated January 24, 1983. 69 Fed. Res. Bull. 105 (1983).

26/ SIA v. Board of Governors of the Federal Reserve System, pending before the U.S. Court of Appeals for the Second Circuit, Civil Action No. 83-4019.

27/ 48 Fed. Reg. 22989 through 22991.

28/ West Deutsche Landesbank, A West German Supreme Court decision, July 1982, reported in The Economist, March 26, 1983, p. 50.

29/ This was a specific focus of the Supreme Court in its review of Congressional concern in this field. ICI v. Camp, 401 U.S. at 630-631.

30/ See "The Debt-Bomb Threat", Time, January 10, 1983, pp. 42-51.

31/ See "Penn Square Blowout Ended a Lending Spree as Risky as Oil Drilling," The Wall Street Journal, July 27, 1982.

32/ See "How New York Bank got itself Entangled in Drysdale's Dealings," The Wall Street Journal, June 11, 1982.

33/ Loss of public confidence in the stability of the banking system resulting from its involvement in securities activities was a primary concern of Congress in enacting the Glass-Steagall Act. See ICI v. Camp, 401 U.S. at 631.

34/ "Failures seen Higher in 1983," American Banker, June 1, 1983.

35/ These concerns, as well, motivated Congress in passing the Glass-Steagall Act. See ICI v. Camp, 401 U.S. at 631.

36/ See, "Some Banks Accused of Conflicts of Interest in Hostile Takeovers," The Wall Street Journal, March 16, 1979, 1 describing General Cable's takeover of Microdot. See also, 115 Cong. Rec. 32894 (1969)(remarks of Rep. Patman).

37/ One Bank Holding Company Legislation of 1970, Hearings Before the Senate Committee on Banking and Currency, 91st Cong. 2d Sess. at 239-40 (1970). See also, Mr. McLaren's remarks before the House Committee: The Bank

Holding Company Act Amendments, Hearings before the House Committee on Banking and Currency. 91st Cong., 1st Sess. at 91-92 (1969).

38/ Statement of Larry F. Clyde, before the Senate Finance Committee on March 17, 1982.

39/ IRC § 582(a) and IRC § § 166(a)(b).

40/ IRC § 585.

41/ *See New York Stock Exchange, Inc.* v. *Bloom*, 562 F.2d 736 (D.C. Cir., 1977), *cert*. *denied*, 435 U.S. 942 (1978).

42/ E. Gerald Corrigan, President of the Federal Reserve Bank of Minneapolis addressed some of those problems in a monograph titled, "Are Banks Special?" 1982 Annual Report of the Federal Reserve Bank of Minneapolis.

43/ Parts of this problem have been explored by the SEC and the U.S. Small Business Administration in two reports "Initial public offerings of common stock: the role of the regional broker/dealers in the capital formation process" Phase I Report, March 1980, and "The Role of Regional Broker/Dealers in the capital formation process: underwriting, market-making and securities research activities," Phase II Reports, August 1981 and by the SEC in "Bank participation in Municipal Revenue Bond Underwriting: Impact on Securities Industry Revenues," October 19, 1979.

44/ See SIA's testimony before the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs, February 12, 1982.

Senator HECHT. Thank you very much. In the interest of time, may I ask the rest of the panel to maybe condense their remarks. We have one full panel and we have a busy morning this morning. So submit your remarks for the record, and if you can possibly condense them, we'd appreciate it.

Mr. Silver.

STATEMENT OF DAVID SILVER, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. SILVER. Yes. Thank you, Senator Hecht. I do have a written statement for the record. I will be as brief as possible in my summary of the written statement.

Senator HECHT. Excuse me. I didn't properly address you. You are president of the Investment Company Institute.

Mr. SILVER. Yes, sir. Thank you. And if my written statement would be submitted for the record.

Senator HECHT. Thank you. Yes, it will be.

Mr. SILVER. Senator, previous witnesses have discussed the public policies underlying the Glass-Steagall Act: Assuring safety and soundness, avoiding conflict of interest, and preventing excessive concentration of economic power. On the other side, various arguments have been advanced in favor of modifying or repealing Glass-Steagall. I would like to address some of these arguments, specifically as they refer to the mutual fund industry.

First there was the argument last year that Glass-Steagall had to be changed in order for banks to compete against money market mutual funds. But as this committee correctly concluded last year, the competitive problem had nothing to do with Glass-Steagall, but was caused by regulation Q. Although the new bank deposit account has its own problems, notably the ability of banks to issue federally guaranteed debt without interest restraints, it is clear from the success of these new accounts that the money market fund rationale for abandoning Glass-Steagall has disappeared.

BANKS HAVE NOT LOST GROUND IN THE DOMESTIC MARKETPLACE

Second, we have heard that Glass-Steagall must go because commercial banks are losing market share to other types of financial intermediaries. This is not true. Recent studies by the Federal Reserve Banks of Chicago and Minneapolis indicate that banks have not lost ground in the domestic marketplace in the last three decades. But even if there had been some loss of market share, it is questionable whether it would be wise for Congress to act to increase banking's share of the financial markets. Commercial banks account for almost 38 percent of all financial assets, more than twice as much as S&L's and almost three times the holdings of life insurance companies. Moreover, bank assets are highly concentrated, with the 15 largest banks accounting for over 33 percent of all insured bank assets. We do not see that the time has come for Congress to devise a system of financial food stamps to enable large banks to swallow competing businesses and further concentrate economic power in a few hands.

Third, it is argued that bank expansion into the securities business is necessary because of mergers in the financial services industry; however, the most important of these mergers—Prudential-Bache, Sears-Dean Witter—involved mergers of nonbanking firms. Other developments involved the creation or acquisition of trust companies having nothing to do with commercial banking These types of mergers and acquisitions have been going on for many years without affecting the banking industry or bank market shares.

There have been a few instances, particularly in recent months, in which combinations have occurred in one form or another between banks and other firms. These developments, not yet widespread, do have the potential for undermining Glass-Steagall as well as the geographic restrictions of the McFadden Act. However, unless this committee is convinced that the Glass-Steagall and McFadden Acts serve no useful purpose and should be repealed, legislative steps should be taken now to correct this incipient regulatory breakdown in its early stages, to provide time for a rational decision to be made as to the continued viability of the historic policies embodied in these laws. The Institute's board of governors has unanimously endorsed the enactment of a fair, balanced moratorium to prevent a run-away proliferation of combinations that would be difficult to undo.

The committee, we think, should also inquire carefully into how and why these combinations— which clearly violate the intent of the law—are suddenly occurring. We are concerned that the answer is not to be found in the fact that lawyers have suddenly stumbled across hidden loopholes, but that the bank regulatory agencies, which are supposed to interpret the laws to effectuate their purpose have decided to substitute their judgment as to appropriate public policy for that of the Congress. To be blunt, we believe that the bank regulatory agencies are engaging in statutory book-burning and that Congress ought to put a halt to this invasion of the constitutional congressional prerogative to set public policy.

The final argument advanced for legislation to permit the banks to enter the mutual fund business is that of the revolution in technology. Thus far, much of the talk of the interaction between technological innovation and the concurrent move to financial conglomeration is just that: talk. The actual economic penetration between the core of the traditional banking and securities industries is minute, and in the main, technology thus far has simply made traditional ways of doing business more efficient.

WHO IS BEHIND THE MOVE TO REPEAL GLASS-STEAGALL?

It may be instructive to consider who is behind the move to repeal Glass-Steagall to determine who would be the beneficiaries, and from that to deduce the effect on competition. First, we know it is not the 12,000 or so smaller banks who have any urge to enter the securities business, and we likewise know there has been no enormous enthusiasm for repeal of Glass-Steagall by the savings and loan industry. The Nation's credit unions do not seem to be consumed with a passion to create mutual funds. I think we all know where the current push to repeal Glass-Steagall comes from. It is precisely from the same quarters that opposed the enactment of the original law 50 years ago and who have sought its repeal and that of McFadden ever since.

Indeed, the statistical data tell us precisely who these beneficiaries would be. It is those large banks with well developed trust departments who would come to dominate the mutual fund business just as they dominate the trust business. Again, the data show that present concentration is startling. Total trust assets of the 15 largest banks account for over 34 percent of all such moneys administered by the banks.

Indeed, the $204 billion in trust assets managed by these 15 banks is almost three-quarters of the total assets managed by the entire mutual fund industry. Repeal the Glass-Steagall Act and I can assure you that the investment management function will be concentrated and centralized in these few giant banks. Make no mistake about it. Despite all the talk of competition, when the second-largest bank in the country decided to enter the discount brokerage business, it did not open up a competitive shop. It went out and bought the biggest discount brokerage house in the country.

Now, the reasons for bank dominance of nonbanking fields have been discussed at these hearings. Members of this committee—including you, Senator Hecht—have spoken about tie-ins and various forms of debtor coercion. We in the mutual fund industry have seen abundant evidence of this. For example, our members have been continually disadvantaged in competing with banks for the management of corporate pension money. Despite superior performance, our investment advisory members have been made to understand that potential corporate clients dare not disturb their commercial relationships with their banks by withdrawing their pension funds from bank trust departments. Some may argue that these fears are overstated, but would anybody be willing to assure a businessman that all will go well with his vital banking relationship if he withdraws some of his patronage from his bank? We think the issue of concentration by acquisition, aided and abetted by tie-ins, express or implied, is one to which you should give careful thought.

To date, we have not seen any proponent of repeal of Glass-Steagall advance any solution to the tie-in problem, or, indeed, argue that it is healthy to set the stage for even greater concentration of financial assets than already exists.

I should like to close by merely noting that we await the 1983 version of the Treasury bill to permit bank entry into the securities business. I am willing to venture that it does not address the inherent problems afflicting last year's model. Relying on an affiliate concept as a panacea for the ills of the past—it is difficult to see how the Treasury approach is an effective cure.

Senator Hecht, this morning you opened by asking a question: "What would Senator Glass and Congressman Steagall be most surprised about if they were here today?" I think if they were here this morning, my next sentence answers that question: Reliance on securities affiliates to cure the problem of bank entry into the securities business is absurd.

The fact is it was the securities affiliates which dragged down the Nation's largest banks in the debacle of the 1920's, and the great problem of the REIT's in the 1970's spilled over to their parent banks and also started in separate affiliates.

So I think the thought that the affiliate concept has fewer problems would be among the largest surprises that the Senator and the Congressman would face this morning. The fact is, separating business functions into corporate affiliates does not effectively quarantine a commercial enterprise from the spread of infection.

Thus, without specialized legislation to guard against unique conflicts of interest and other problems arising from bank securities activities, we think the Treasury proposal is deficient in relying on a legalistic separation of functions which will prove to be futile when put to the test.

We do believe that the affiliate approach, insofar as it lays the groundwork for specialized and functional regulation, does make sense. But much more work needs to be done. Here we agree with the recommendation of the American Assembly of Columbia University which talks in terms of replacing Glass-Steagall with, and I quote, "appropriate provisions addressing the problems of undue concentration of economic power and conflicts of interest in all financial services."

We also agree with the related recommendation of the American Assembly calling for common regulation of all pooled investment funds whether conducted in trust or agency form. We are pleased to note that Chairman Shad of the SEC directly and emphatically agreed with the necessity for equal regulation of bank common, and collective funds and mutual funds.

In short, we believe that the principles underlying the Glass-Steagall Act remain sound, that neither the public nor the banking industry has suffered any disadvantage by bank exclusion from the securities business. However, if Congress decides to enact legislation to modify Glass-Steagall, we are prepared to cooperate in fashioning a new and appropriate regulatory scheme which provides for adequate protection of the public and competitive equity.

However, should Congress decide to embark on such an endeavor, it must be approached with the realization by all parties that major readjustments in traditional regulatory patterns would be involved, that notions of geographical isolation must likewise be placed in the crucible of change, and most importantly, that the banking business can no longer be isolated from the vicissitudes of the competitive marketplace. Thank you.

[The complete statement follows:]

WRITTEN STATEMENT OF THE INVESTMENT COMPANY INSTITUTE BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS ON CONDITIONS IN THE FINANCIAL INSTITUTIONS INDUSTRY
98th CONGRESS, FIRST SESSION

(June 16, 1983)

My name is David Silver. I am President of the Investment Company Institute.

The Investment Company Institute is the national association of the American mutual fund industry; its membership includes 889 open-end investment companies, or mutual funds, which account for over 90% of the industry's assets of $286 billion. Today, more than 16 million investors hold shares of mutual funds. Accordingly, we are vitally interested in preserving and enhancing both an efficient investment climate and a healthy financial system. We greatly appreciate the opportunity to testify before you concerning conditions in the financial institutions industry.

Previous witnesses at these hearings have discussed the various laws governing our nation's financial institutions and the public policies underlying those laws -- assuring safety and soundness; avoiding conflicts of interest, fraud and consumer abuses; and preventing excessive concentration of economic power. These policies formed the basis of financial regulation well before the enactment of the present regulatory system, and we believe that they should remain as goals for the future.

One of this nation's historic public policies, which long antedates the enactment of the Glass-Steagall Act, is the separation of commercial banking and commerce.*

In recent years the nation's largest banks have sought legislation to amend the Glass-Steagall Act to permit them to enter the mutual fund business based on the argument that this was needed in order to allow banks to compete against money market mutual funds. At numerous hearings, including those conducted by this Committee, the Institute consistently took the position that the proper course of action was not to repeal the Glass-Steagall Act, but was rather to permit banks and other depository institutions to offer deposit accounts which would be competitive with money market funds. Last year, in the Garn-St Germain Act, Congress enacted such legislation, authorizing banks and other depository institutions to offer deposit accounts which are "directly equivalent to and competitive with money market mutual funds."

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* For example, in 1911, the Solicitor General of the United States issued an opinion, concurred in by the Attorney General, that national banks were precluded from engaging in the investment company business through separate affiliates, stating:

> "And there is a larger interest, that of depositors and of the National Government, which requires that the bank shall be conducted as a bank pure and simple and not as a promoting agency of speculative investment companies."

Opinion of Solicitor General Lehmann, Nov. 6, 1911, quoted in 75 Cong. Rec. 9899, 9902 (1932).

The success of the new Money Market Deposit Accounts and Super-NOW Accounts is apparent. As of May 18, 1983, these accounts had assets of $387.1 billion. During the period December 1, 1982 to May 25, 1983, the assets of money market mutual funds fell from $232.6 billion to $170.4 billion. Thus, it is obvious that repeal of the Glass-Steagall Act is not needed in order to permit banks to compete effectively against money market funds.

Undaunted, the proponents of Glass-Steagall repeal legislation now offer three new rationales purportedly justifying bank entry into the mutual fund business.

First, they argue that such legislation is needed because banks allegedly are losing market share to non-banking firms.

Before commenting on the validity of this claim, it would be well to have in mind the present distribution of financial assets among American financial institutions. Table I shows that commercial banks hold about $1.6 trillion in financial assets, or almost 38 percent of all financial assets owned by major types of financial institutions. Bank holdings of these assets are more than twice the level of such assets held by savings and loan associations and almost three times the level of holdings of life insurance companies.

When the measurement of bank assets is broadened, the total is much larger than the $1.6 trillion cited above. Total assets of all insured commercial banks, for example, amount to [illegible] $2.2 trillion when items such as the assets of foreign [illegible] and physical assets are included. As shown in Table [illegible], the largest 15 commercial banks hold 33 percent of total assets held by all insured banks. At this level of concentration it is not clear that a supposed "loss of market share" by commercial banks presents an appealing case for legislative relief.

The fact is however that recent studies belie the argument that commercial banks are losing market share. An April 1983 Staff Memoranda prepared by Members of the Research Department of the Federal Reserve Bank of Chicago states:

> "[A]fter a sharp loss in market share in the years following World War II, banks seem to have held their own since 1960. Data from the Flow of Funds accounts...indicate that, although bank holding companies have gained market share in some product lines and lost share in others, their share of total financial intermediation as measured by assets has varied between 36.5 percent and 39.5 percent in the 1960-81 period. The employment and employee compensation data...also provide evidence of the continued strength of banks' position in the financial services sector."*

Similarly, the 1982 Annual Report of the Federal Reserve Bank of Minneapolis states:

> "By using the flexibility provided by the Bank Holding Company Act, by developing sophisticated liability management techniques, by major expansions abroad, and by creative and innovative adaptations of 'conventional' banking services, banks have actually fared rather well in terms of preserving their overall market position. While it is not easy to measure what has happened to the relative position of banks over time, the appendix to this report [appendix omitted] makes such an effort. Allowing for the inherent measurement problems in such an exercise -- to say nothing of the data limitations -- the analysis simply does not bear out the perception noted earlier that banks have lost ground in the domestic marketplace over the past three decades. (While not captured by the data, banks have, of course, made major expansions abroad during this period.)"

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* Kaufman, More and Rosenblum, "The Future of Commercial Banks in the Financial Services Industry", at 17.

The second argument put forth by proponents of legislation to authorize banks to sponsor mutual funds is that this is needed to counter mergers by non-banking firms. However, many of the most publicized of these mergers (such as Prudential's acquisition of Bache and Sears' acquisition of Dean Witter) do not involve the combination of banking and non-banking firms, but rather of two non-banking institutions. In fact these acquisitions are simply the most recent examples of mergers among non-banking financial institutions which have been going on for many years, without decreasing banks' share of the financial services market.* Further, many of the acquisitions by non-banking firms of "banks" have actually involved acquisitions of trust companies, and not of institutions which accept deposits and make commercial loans. These acquisitions obviously do not involve a combination of "banking" and "commerce",* and again this trend is not new -- a number of mutual fund organizations have operated trust companies for many years. Finally, there are very few instances in which combinations have involved securities firms and banks. And what must be emphasized is that each of the securities firm-bank combinations only took place due to the explicit or tacit approval of a bank regulatory agency. Thus, Bank of America's acquisition of Schwab, a discount broker, was approved by the Federal Reserve Board, Dreyfus' acquisition of a state bank in New Jersey was approved by the Comptroller of the Currency; and Washington Mutual Savings Bank's acquisition of Murphey-Favre, a mutual fund sponsor and broker-dealer, was permitted by the FDIC, based on its remarkable discovery of a heretofore non-existent loophole in the Glass-Steagall Act.**

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* For example, in the late 1960s, many major insurance companies entered the mutual fund business, usually by acquiring existing mutual fund organizations. Indeed, something like one-third of the mutual fund industry was acquired by major insurance companies. Other large corporations, including the New York Central Railroad, IT&T, Marsh & McLennan and the Gates Rubber Company have at various times done likewise. But in fact none of these mergers had had earthshaking consequences, and there is no reason to believe that the latest mergers will prove any different. Indeed, the President of Prudential-Bache Securities, Inc. recently predicted that "the entire notion of one-stop financial shopping will be discredited" and characterized the concept as "specious" and one which "will only serve to create a bedpan of red ink", Prudential-Bache Chief Questions Prevalent Views on Industry's Future", American Banker, February 1, 1983. Similarly, the Chairman of the Board of the Vanguard Group recently stated that "perhaps as many as 90% of the new mergers will be spun off by 1993", Vanguard Plans Host of New Services, American Banker, April 18, 1983.

Thus, the facts demonstrate that few combinations of securities firms and banks have actually occurred, that those which have taken place have resulted from actions taken by federal banking agencies, and that such combinations could be prevented if those agencies simply utilized their powers of supervision in a manner consistent with the policy and clear intent of the Glass-Steagall Act.

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* As the preeminent authority of American trust law, Professor Austin Scott, stated: "There is no necessary connection between the business of banking and the business of administering trusts." Scott, Fifty Years of Trusts, 50 Harvard Law Review 60, 62 (1936).

** Indeed, the FDIC recently proposed expanding the alleged loophole by proposing to authorize 9,000 state-chartered banks to become affiliated with firms which engage in all forms of securities underwriting.

The final argument being advanced for legislation to permit banks to enter the mutual fund business is that of the alleged revolution in technology. However, much of the talk of the interaction between technological innovation and the concurrent move to financial conglomeration is just talk. As I previously indicated, the actual economic penetration between the core of the traditional banking and securities industries is minute, and, in main, technology has thus far simply made traditional ways of doing business more efficient. Moreover, public policy demands that actual or predicted technological change not provide the sole basis for abandoning public policies which have their own rationales having nothing to do with the state of the art in the computer business.

In short, each of the arguments currently being advanced to permit banks to enter the mutual fund business -- banks' alleged loss of market share, mergers of non-banking firms and technological innovation -- ignore the fundamental national policies which led Congress to enact the Glass-Steagall Act 50 years ago.

It is most instructive to consider which segments of the banking industry are pushing for entry into the mutual fund business.

It is not the thousands of small banks located throughout the country since, as a recent report prepared for the American Bankers Association concluded: "For the small community bank, [mutual] fund management is not cost effective. A community bank cannot generate the critical mass, the break-even volume, that is required to profitably manage funds."* Indeed, according to the American Banker, the FDIC's recent proposal to permit 9,000 smaller banks to enter the mutual fund business "has barely created a ripple of interest among banks that could engage in such activity."** In fact, a representative of the Independent Bankers Association of America, the association of the nation's small banks, recently told this Committee: "Now traditionally, financial services have been separated -- and I think for very good reasons because there is enormous potential for conflict of interest."***

Similarly, pressure to repeal Glass-Steagall is not coming from the smaller thrift institutions. On May 20 the Vice President of the National Association of State Savings & Loan Supervisors, in response to a question from Senator Hecht, stated that in his own state "We might have two institutions in Louisiana out of 119 that have that capability [for securities activities] today. I don't even know that it's a profitable capability for the future."****

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* Assessment of Business Expansion Opportunities for Banking, March 1983, at 243.

** FDIC Proposal for Bank Securities Underwriting Attacked by Legislators, American Banker, May 26, 1983.

*** Transcript of May 3, 1983, at 22.

**** Transcript of May 20, 1983, at 43-44.

Instead, the current push to repeal the Glass-Steagall Act is coming from the same quarters who opposed enactment of the original legislation 50 years ago,* and who have sought its repeal (and the repeal of the McFadden Act and the Douglas Amendment)** ever since -- the handful of the nation's giant banks and bank holding companies who seek to offer all financial services on a nationwide basis.

It is possible from the available statistical data to predict the beneficiaries of any modification of Glass-Steagall to allow banks to create and distribute mutual funds. The total trust assets, including collective funds, of the fifteen largest banks operating in this area account for over 34% of all such monies administered by banks (See Table III). The $204 billion represented by these fifteen banks is almost 3/4 of the total assets managed by the entire mutual fund industry. It is precisely these banks which have shown the greatest interest in seeking to enter the securities business. There can be little doubt that if they succeed, the investment management function will become far more concentrated and indeed centralized in a relatively few giant banks. Indeed, on the fiftieth anniversary of the Glass-Steagall Act it is interesting to compare the large banks' current goals with their expansionary program of the 1920s: today they seek to become "financial supermarkets", in the 1920s they aspired to become "department stores of finance."[8]

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* "I believe this effort to segregate investment banking from commercial banking is unwise, and would serve no purpose sufficient to justify the abrupt scrapping of investment machinery developed through the years by natural forces." Francis H. Sisson, Vice President of the Guaranty Trust Company of New York and President of the American Bankers Association, "Supervision or Suppression," American Bankers Association Journal, February 1933, at 13.

** "The prohibition against interstate banking had kept banks across the country safe from the incursions of the handful of giant, would-be national banks. Such laws he [the Chairman of Citicorp] argued, had to go." Bennett, Inside Citicorp: the Changing World of Banking, The New York Times Magazine, May 29, 1983, at 16.

History demonstrates what is likely to occur if large banks are permitted to enter the mutual fund business.

First, there will be no increase in competition. Rather than creating their own mutual fund organizations, large banks will simply buy existing large mutual fund organizations -- accelerating concentration. For example, when Bank of America decided to enter the discount brokerage business, it did not start a discount brokerage operation from scratch or even buy and then expand a small existing broker. Instead, the nation's *second largest bank* simply bought the nation's *largest discount broker*.

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[8] Compare the goals of Citicorp's current Chairman:

> "He sees Citicorp as one of a handful of financial supermarkets--including the likes of Prudential-Bache and Merrill Lynch--that will be able to handle virtually any transaction. These giants, communicating with customers by means of computer terminals in the home, will sell stocks and bonds and insurance and even permit a customer to shop for food and clothing without moving from his chair." Ibid. at 15.

with the goals of the nation's large banks in the 1920s:

> "The new era banker felt he must rescue the people by encouraging them to come to the bank for investment advice. The small investor was told that he should share the opportunity to grow rich with America, by putting his money in investment trusts [mutual funds]. In order to facilitate this new service many large banks organized investment trusts of their own.....Another part of the new era philosophy in banking was that a bank must be big to be successful and sound. Banks were to become 'department stores of finance' offering all types of financial service under one roof. Bigness became a fetish." James Gerald Smith, "Banking and the Stock Market", Chapter VI of Facing the Facts (1932), at 157.

Second, history, as well as the data showing the present degree of concentration of investment management in large banks, indicates that these banks are likely to dominate the mutual fund business as they have dominated other sectors of the securities industry they have entered in the past. For example, following the enactment of legislation in 1927 permitting national banks to underwrite all corporate securities:

> "Commercial banks became increasingly more active in the securities markets; their market share of new bond issue participations was boosted from 37 per cent in 1927 to 61 per cent in 1930 .... By the end of the decade commercial banks and their affiliates had become the dominant force in the investment banking field."*

Similarly at year-end 1975, the most recent year for which figures are available, commercial banks and trust companies managed over 64% of all private non-insured pension assets,** despite widespread belief that banks have not provided investment results equal to those of other investment managers.

The banks' ability to dominate non-banking businesses they enter stems from banks' government license to accept deposits and to lend those deposits to millions of individuals and institutions, thus making banks the dominant source of credit in the United States. This unique power gives commercial banks an inherently unfair competitive advantage over all other businesses in the offering of non-banking products and services -- a thought expressed by Senators Proxmire, D'Amato and Hecht as well as other members of the Committee. As Senator Proxmire stated a few years ago:

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* Perkins, "The Divorce of Commercial and Investment Banking: A History," 88 Banking L.J. 483, at 495 (1971) (footnote omitted).

** Securities and Exchange Commission, 35 Statistical Bull. at 553 (1976).

> "Unfair competition arises because many customers will prefer to give their commercial business to a bank which also dispenses credit, even at a higher price, rather than to purchase their services from a nonbank competitor. Tie-in sales, whether coerced or voluntary, distort our economy and free market. This distortion means that trade is no longer carried out on the basis of price, quality, and service but on the basis of hoped for favortism."*

In some cases, banks' tying of loans to the provision of other products and services is explicit and is even permitted by law. For example, the 1970 Bank Holding Company Act Amendments expressly permits a bank to tie its extension of credit to trust services, including the management of pension trusts. This anti-competitive provision helps explain why banks dominate the pension market, despite banks' inferior investment performance.*

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* 125 Cong. Rec. S 236 (daily ed. Jan. 18, 1979).

In other cases, bank tying of loans to the provision of other products and services is more subtle. A previous witness at these hearings, representing the National Association of Insurance Commissioners, spoke of the "unequal position of the consumer to the lender" and the problem of "debtor coercion."** Similarly, both Senators D'Amato and Hecht have mentioned the "human element" involved when a consumer seeks a loan from a bank and the bank has other products or service to sell.***

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* As an editorial in a magazine specializing in pension affairs explained:

> "What is an observer to think when he sees a roster [of major pension managers] composed almost entirely of banks, most of which have languished near the bottom of the investment performance tables for almost a decade?
>
> "Would he be unjustified in suspecting that the poorly performing banks are maintained as managers more for what they can do for the corporation than what they can do for the plan beneficiary?
>
> "Many observers suspect that some large banks have maintained their pension clients over the past eight or nine years mainly because they have commercial ties with those clients. To complicate the issue, clients fear corporate relations will be jeopardized if they fire the banks as pension fund managers." "Investing Solely In Interest of Beneficiaries," Pensions & Investments, January 1, 1979, at 6.

** Transcript of May 20, 1983, at 38.

*** Transcript of April 6, 1983, at 37 and 42.

The Investment Company Institute recently obtained evidence of the "human element" and the potency of "debtor coercion". In 1980 we retained an independent market research firm to study the small retirement plan (below $10 million) market. Over one-third of the firms surveyed rated their company's commercial banking relationship as being "very important" in selecting a pension manager.

The bottom line is that bank entry into the mutual fund business not only will result in concentration of economic power through large bank acquisition of mutual fund firms and "debtor coercion", but will also produce the very conflicts of interest which led Congress to enact the Glass-Steagall Act. Indeed, Secretary Regan has recognized the fact that bank mutual fund activity "does raise all the traditional Glass-Steagall concerns."* The Secretary then expressed the belief that the Administration's proposed legislation requiring the use of affiliates, in company with existing banking and securities laws, provides adequate safeguards against self-dealing transactions.

We strongly disagree with the Secretary's belief in the adequacy of the protections provided by the use of separate affiliates and by the application of existing banking and securities laws.

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* Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs on S. 1720, 97th Cong., 2d Sess. (1982) at 9.

First, as Chairman Garn and others have repeatedly pointed out, the mere creation of an affiliate does not solve the types of problems which existed in the 1920s or those which developed in connection with bank sponsored Real Estate Investment Trusts during the 1970s. Testifying last week before this Committee SEC Chairman John Shad stated: "This [affiliate] proposal would provide regulation by functional activities. However, it should not be regarded as the sole means to protect depositary institutions from risks that are incompatible with their special needs."*

Second, the existing banking laws cannot provide adequate safeguards since the banking laws are designed to insure the safety and soundness of the banking system, and not to protect investors. As William Cary, the distinguished former Chairman of the SEC, stated: "The great objectives of banking regulation are controls over the flow of credit in the monetary system, the maintenance of an effective banking structure, and the protection of depositors. These objectives neither utilize the same tools nor achieve the same ends as investor protection."*

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* Statement of John S.R. Shad, Chairman of the Securities and Exchange Commission, Before the Senate Committee on Banking, Housing and Urban Affairs, June 8, 1983, at 16.

Finally, the existing securities laws will not provide adequate safeguards. The existing securities laws, notably the Investment Company Act of 1940, were enacted by Congress to deal with the unique and specific conflicts which arise when investment banking firms, brokerage firms and investment advisers sponsor, manage and distribute the shares of investment companies. However, the Act does not purport to deal with the unique conflicts of interest which result when commercial banks or their affiliates engage in the investment company business, since when it enacted the Investment Company Act, Congress believed that the Glass-Steagall Act prohibited banking institutions from engaging in the investment company business. As SEC Chairman Shad has testified:

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* Testimony Before the Securities Subcommittee of the Senate Committee on Banking and Currency, 88th Cong., 1st Sess., at 20 (1963).

Or as current SEC Chairman John Shad, testifying just 20 years later, similarly observed:

> "The regulatory schemes under which bank-sponsored collective investment vehicles and investment companies organized and sponsored by securities firms operate are substantially different. Some collective investment products offered by banks are subject to the federal securities laws; others are not. Those that are regulated exclusively under the banking laws are subject to standards that are not as meaningful as those of the federal securities laws. This disparity of regulation can be traced to the differing orientations of banking and securities regulation. Banking laws and regulations emphasize stability of banking institutions and protection of depositors' funds; securities laws and regulations focus on investor protection through full disclosure."

Statement of SEC Chairman Shad, _Ibid_, at 17.

> "The Investment Company Act was adopted after the Glass-Steagall Act separated commercial banking from investment banking. Therefore, the Investment Company Act could not address the problem of bank conflicts of interest specifically."*

Therefore, as Chairman Shad, Chairman Volcker and Governor Partee testified, if commercial banks or their affiliates are permitted to organize, sponsor and distribute the shares of investment companies, it will be necessary to revise the Investment Company Act to deal with the unique conflicts of interest which are likely to result.

When the Institue testified before the Securities Subcommittee of this Committee last February, we offered specific amendments to deal with the specific problems identified by Chairman Volcker, Governor Partee, Chairman Shad and other witnesses. We frankly are uncertain whether amendment of the Glass-Steagall Act to permit banks to sponsor mutual funds, even if accompanied by all of the provisions we and other witnesses have suggested, will ensure that future problems, similar to those of the 1920s or the bank REIT debacle of the 1970s will not occur. However, we fear that enactment of such legislation, without the imposition of these or similar protections, is a prescription for the recurrence of the same abuses which the Glass-Steagall Act and its predecessor laws were enacted to prevent.

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* Statement of the Securities and Exchange Commission, Hearings Before the Senate Committee on Banking, Housing and Urban Affairs on the Financial Institutions Restructuring and Services Act of 1981, 97th Cong., 1st Sess. (1981), Pt. II at 914.

In this connection, I note that Chairman Garn has placed in the Congressional Record the Report issued by the American Assembly of Columbia University on "The Future of American Financial Services Institutions". Following a three day meeting in April of representatives of Congress, the executive branch, regulatory agencies, the financial services industry, the law, the universities and communications media, the Assembly adopted a Report which talks in terms of replacing the Glass-Steagall Act with "appropriate provisions addressing the problems of undue concentration of economic power and conflicts of interest in all financial services and for the fair and equitable access to all financial markets."

We concur. If Congress decides to enact legislation authorizing bank sponsorship of mutual funds, it is essential that the legislation simultaneously deal with the competitive and regulatory problems which automatically will arise from modification of the Glass-Steagall Act. Problems resulting from past bank excursions into the securities business demonstrate that it will not do simply to amend the Glass-Steagall Act now and hope for the best in the future.

We also strongly concur in another recommendation made by the American Assembly:

> "Supervision and regulation should be according to types of financial products or along other functional lines. For example, securities underwriting, as well as dealing and brokerage, should be subject to common statutes and common regulator, as should money management and investment advisory activities, whether conducted in trust, agency, or pooled forms."

In our previous testimony before this Committee and its Securities Subcommittee we urged that any legislation authorizing banks to enter the mutual fund business also place existing bank pooled investment funds -- notably bank common trust funds and collective investment funds -- under the federal securities laws. We noted that banking regulations initially authorized these funds as simple pooling devices for the assets of bona fide trusts already managed by the bank, and totally prohibited merchandising and advertising. We pointed out that Congress exempted these funds from regulation under the federal securities laws based on these restrictions. However, we noted that _after_ Congress acted, the Comptroller of the Currency amended his regulations to permit banks to mass-merchandise interests in bank collective funds to hundreds of thousands of retirement plans and to individual employees in those plans. We discussed the abuses which are taking place due to the funds' exemptions from the federal securities laws in the areas of advertising, lack of disclosure and self-dealing transactions. Finally, we noted that members of Congress and agency officials have called for legislation to subject these funds, which have in fact become mutual funds, to appropriate regulation under the federal securities laws.*

Since we last testified, the problem has intensified. The Comptroller of the Currency has authorized Citibank, the nation's largest bank, to mass-market interests in a "common trust fund" to the 111 million Americans eligible to establish Individual Retirement Accounts, and to do so completely free from regulation under the federal securities laws.

The Comptroller's action exemplifies our earlier point -- any breakdowns in the Glass-Steagall Act result from the actions of the federal banking agencies who apparently are seeking to circumvent the Congressional process by legislating through agency action.

The Comptroller's action also underscores the need for the legislation urged by the American Assembly -- subjecting _all_ pooled investment funds to "common statutes and a common regulator." The investment pools sponsored by banks bear little or no resemblance to the traditional fiduciary activities offered by bank trust departments 50 years ago. They are now garden variety securities activities. We submit that the time has come to rectify this situation by subjecting these bank pooled funds, which have assets of over $100 billion, to a meaningful and uniform scheme of federal securities regulation.

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* The last such call occurred at the present hearings when, on June 8, 1983, Chairman Shad of the SEC extensively analyzed the existing regulatory anomalies and concluded: "In order to eliminate the regulatory anomalies that arise under the existing structure of regulation of investment management, it would be desirable to create a new regulatory scheme that would subject all collective investment vehicles -- common trust funds, pooled employment benefit plans, and investment companies -- to comparable regulation." Statement of SEC Chairman Shad, _Ibid_, at 19.

TABLE I

FINANCIAL ASSETS OF COMMERCIAL BANKS AND OTHER TYPES OF FINANCIAL INSTITUTIONS, 1982*

TYPE OF FINANCIAL INSTITUTION	BILLIONS OF DOLLARS	PERCENT DISTRIBUTION
COMMERCIAL BANKS	$1,594.6	37.7%
LIFE INSURANCE COMPANIES	561.0	13.3
OTHER INSURANCE COMPANIES	202.7	4.8
SAVINGS AND LOAN ASSOCIATIONS	706.0	16.7
MUTUAL SAVINGS BANKS	174.7	4.1
CREDIT UNIONS	87.2	2.1
PRIVATE PENSION FUNDS	344.9	8.2
STATE AND LOCAL RETIREMENT FUNDS	257.4	6.1
OPEN-END INVESTMENT COS.	296.6	7.0
TOTAL	$4,225.1	100.0%

*NOTE: Data compiled from a preliminary Federal Reserve Flow-Of-Funds Report dated February 22, 1983.

TABLE II

FIFTEEN LARGEST U. S. BANKS AND THEIR CONSOLIDATED ASSETS YEAR-END 1982*

BANKS	CONSOLIDATED ASSETS (BIL. of $s)
1. BANK OF AMERICA	$ 119
2. CITIBANK	111
3. CHASE MANHATTAN	79
4. MANUFACTURERS HANOVER	59
5. MORGAN GUARANTY	57
6. CHEMICAL	47
7. CONTINENTAL ILLINOIS	41
8. BANKERS TRUST	40
9. FIRST NATIONAL OF CHICAGO	35
10. SECURITY PACIFIC	34
11. CROCKER NATIONAL	24
12. WELLS FARGO	22
13. FIRST INTERSTATE	21
14. MELLON	21
15. MARINE MIDLAND	20
TOTAL - FIFTEEN LARGEST BANKS	$ 730
TOTAL - ALL INSURED BANKS	$2,187

NOTE: Federal Reserve data from insured commercial banks Report of Condition, December 31, 1982.

TABLE III

TOTAL ASSETS OF THE FIFTEEN LARGEST BANK TRUSTS IN RELATION TO TOTAL TRUST ASSETS, END OF 1981*

BANK	NAME OF BANK	TOTAL ASSETS (Bil.of$s)	CUMULATIVE PERCENTAGE: ASSETS OF INDIV. BANKS AS A PERCENT OF TOTAL
1	MORGAN GUARANTY TRUST	$ 35.2	6.0%
2	CITIBANK	19.8	9.4
3	BANKERS TRUST COMPANY	19.5	12.7
4	PROVIDENT NATIONAL BANK	15.9	15.4
5	CONTINENTAL ILLINOIS	13.2	17.7
6	MELLON BANK	12.3	19.8
7	HARRIS TRUST & SAVINGS BANK	11.3	21.7
8	MANUFACTURERS HANOVER TRUST	11.2	23.6
9	THE NORTHERN TRUST COMPANY	10.7	25.4
10	BANK AMERICA NATIONAL TRUST	10.0	27.2
11	CHEMICAL BANK	9.7	28.8
12	WELLS FARGO BANK	9.4	30.4
13	UNITED STATES TRUST	9.1	32.0
14	THE CHASE MANHATTEN BANK	8.7	33.5
15	WILMINGTON TRUST	8.5	34.9
	FIFTEEN LARGEST TRUSTS	$204.5	34.9%
	ALL BANK TRUSTS	$585.8	100.0%

*NOTE: Data obtained from "Trust Assets of Banks And Trust Companies, 1981." This report is compiled by the Comptroller of the Currency; the FDIC; and the Federal Reserve.

POSITION OF THE INVESTMENT COMPANY INSTITUTE WITH RESPECT TO 1983 CONGRESSIONAL HEARINGS ON THE GLASS-STEAGALL ACT AND RELATED LAWS

The Board of Governors of the Investment Company Institute looks forward to carefully focused Congressional hearings in 1983 reviewing the Glass-Steagall Act and related banking and securities laws governing our nation's financial institutions. In the past, these matters have been considered as adjuncts to unrelated legislative issues. The Institute is pleased that Congressional committees plan to give these most important matters the independent review which they merit.

The Institute has long supported the legislative philosophy underlying the Glass-Steagall Act which is designed to prevent the conflicts of interest which result from the combination of commercial banking and the distribution and underwriting of securities. While a number of business and technological developments may require that new legislation be devised, it is essential that any such legislation adequately address the continued potential for these conflicts. The Institute welcomes a public dialogue aimed at fashioning a modern financial system which will provide the necessary protections for the public and a fair field of competition for all types of financial institutions.

Background

Congress last addressed regulation of the financial services industry on a comprehensive basis in the 1930s when it enacted a series of laws delineating the activities of various types of financial institutions and establishing different regulatory systems for them. For example, restoring the historic demarcation which had broken down in the first decades of the 20th century, the Glass-Steagall Act prohibited banks and their affiliates from dealing in securities and prohibited securities firms from operating banks. As part of the same process of reform, the federal securities laws established a system for regulating investment bankers, broker-dealers, investment advisers, mutual funds and other persons engaged in the securities business. Congress went on to exempt banks from detailed regulation under the securities laws on the assumption that Glass-Steagall barred banks from virtually every facet of the securities business.

Subsequent Developments

Business and technological developments over the intervening decades make it appropriate that Congress review these laws in order to determine what, if any, changes are needed in order to meet current conditions, while insuring public protection and fair competition. One area which merits particular examination is the regulation of bank securities activities which have developed over the past 50 years.

Banks have expanded the residual securities activities that remained to them after the enactment of Glass-Steagall far beyond the boundaries contemplated by the exemptions they were granted from the securities laws. Banks currently manage over $585 billion in assets, making them the nation's largest investment managers. Banks sponsor common trust funds and collective investment funds with assets of over

$100 billion. Banks have recently mass-marketed retail repurchase agreements -- an uninsured security -- to small investors without the most elementary protections of the securities laws.

Yet banks perform these and numerous other securities activities free from regulation under the securities laws. There is abundant evidence that the absence of securities law regulation in such areas as advertising, disclosure and conflicts of interest, is harmful to investors. The banking laws, whose purpose is to protect the stability of the banking system, do not purport to provide investors with protections equivalent to those afforded by the securities laws, whose sole purpose is investor protection. For example, this past year a federal banking agency justified its reduction of protection for investors in retail repurchase agreements by stating: "In... a highly competitive climate, there is no need to impose requirements designed to protect investors from their own lack of due diligence." Further, the absence of securities law regulation over existing bank securities activities gives banks major unfair competitive advantages over their non-bank competitors. For these reasons, members of Congress and federal regulatory officials have indicated the need for legislation which would subject all public securities activities, by whomever conducted, to regulation under the securities laws.

The Need for a Comprehensive Program

It is essential that legislative changes be considered on a comprehensive basis. Piecemeal changes in one law, without appropriate modification of related statutes, can impair public protections and result in an unfair field of competition. For example, modification of the Glass-Steagall Act to permit banks to engage in the mutual fund business must be accompanied by modification of the securities laws in order to provide investor safeguards tailored to the special problems which are inherent in bank securities activities, just as the securities laws presently contain specialized provisions dealing with the activities of investment bankers, brokers and investment advisers. Further, to prevent a gross competitive imbalance, legislation permitting banks to engage in the securities business should concurrently permit securities firms to engage in the banking business, and to do so on a nationwide basis. If this is not done, large banks will be able to distribute their securities products and services through their well-established correspondent chains of local banks, while securities firms would be restricted by existing legislation -- the McFadden Act and the Douglas Amendment -- to engaging in banking activities in a single state.

Specific Recommendations

While the need for legislative changes and the specific nature of such changes can only be determined after careful Congressional consideration, the following principles are designed to provide public protections and a fair field of competition:

1. Any new bank securities activities should be required to be conducted by separate bank holding company affiliates, rather than directly by the bank itself.

2. New securities activities conducted by these affiliates should be made subject to regulation under the federal securities laws.

3. The securities laws should be amended to address the special problems which will result from these activities. For example, if bank securities affiliates are permitted to operate mutual funds, the Investment Company Act should be amended to deal with the specific problems which will arise, just as the Act currently addresses the specific problems which result when investment banking firms, broker-dealers and investment advisers sponsor mutual funds.

4. Bank securities activities which have developed since the enactment of the reform measures of the 1930s should be transferred to securities affiliates and made subject to appropriate regulation under the securities laws.

5. The securities laws should be amended to take into account modern conditions and new securities products and services which have been developed by both securities firms and banks since the 1930s. This would involve, among other things, common standards for advertising, marketing and promotional expenses.

6. Provisions should be enacted governing transactions between banks and their securities affiliates in order to prevent the misuse of bank resources and information.

7. If banks are permitted to enter the mutual fund business through securities affiliates, mutual fund organizations likewise should be authorized to form holding companies and own banks within them. Further, in order to address the competitive imbalance which would result from the McFadden Act and the resulting correspondent system, mutual fund bank affiliates should be authorized to engage in the banking business on a nationwide basis.

Senator HEINZ [presiding]. Mr. Silver, thank you.

I see Mr. O'Brien is accompanying you. Mr. O'Brien, do you have anything you would like to add?

Mr. O'BRIEN. Nothing, Senator. Thank you.

Senator HEINZ. Thank you very much.

Ladies and gentlemen, our next panel consists of Mr. Donald Treadwell, Mr. Marvin Gilman, and Dr. Thomas Harter. Mr. Treadwell, would you please be our first witness?

STATEMENT OF DONALD H. TREADWELL, PRESIDENT-ELECT, NATIONAL ASSOCIATION OF REALTORS

Mr. TREADWELL. Thank you, Mr. Chairman. My name is Donald Treadwell. I am a realtor from Detroit, Mich., president-elect of the National Association of Realtors, with over 600,000 members who are involved in every facet of real estate. I would like to thank you for the opportunity to appear before you. I have filed a complete statement. And in the interest of brevity, I will summarize a few of the principal points in an oral presentation.

My purpose here is to answer some questions and to propose others which I think the committee should consider. The first one is probably: Why should real estate brokers be interested in a legislative concept that essentially concerns financial institutions?

BASIC FUNCTIONS OF REAL ESTATE BROKERS

Real estate brokers perform three basic functions for the public. First is a marketing function to find buyers for sellers. The second is a technical function to lead buyers and sellers through the intricacies of transferring interest and real property.

The third is an advisory function to assist buyers in determining the availability of funds to close the transaction. And that is the reason we are here, because without the funds there is no real estate transaction for the homeowners of America.

In the past, the third function has been simple, as our financial system was based on local savings and loan associations and banks which accumulated funds from the local community and loaned them out to take care of the needs of the local businessmen, the consumers, and the home buyers. Most funds to buy homes were raised, provided, and administered by essentially local institutions and by the homeowners themselves.

This financial system, which has enabled Americans to have the highest percentage of homeownership in the world, is now being placed in jeopardy by some of the developments that are occurring or being proposed today. I would like to discuss some of these under three general headings.

The first is: Should Congress further deregulate the Federal financial institutions? In general, we say no. Deregulation should not place the maximizing of short-run deposits for depository institutions as the only public need served by our existing federally insured and supported financial institutions.

This committee should consider the long-range availability of credit to individuals and businessmen of all sizes and kinds in all sections of the country in small towns and rural areas as well as in the money center cities.

This committee should also consider the potential harmful effects of the anticompetitive practices. The financial system has served us very well in the past, and we think that great caution should be exercised in making any radical changes.

In examining the role of regulated financial institutions we should recognize that the banks and the thrift institutions are in a special class. They have many Government-granted advantages that are not available to other organizations. These include: Federal deposit insurance; favorable tax treatment, and access to special credit.

The federally supported benefits for depository institutions are very important to assure this Nation of a stable and secure system of depository institutions. Any changes to make these institutions competitors rather than resources for the commerce of this Nation must take into account these benefits and the likelihood that they would provide unequal and unfair competition not only in the financial area but in all other areas, including the service area.

In considering the broadening of the powers of the financial companies to engage in service activities, we are concerned about the ability of a small businessman to compete on a level playing field. A bank holding company subsidiary decidedly has a clear competitive advantage over a local real estate broker, a property manager, appraiser, or homebuilder that does not have a special relationship with a federally supported financial institution.

PROBLEMS OF TIE-IN SALES

Access to credit is the crux of our industry, and for this reason alone bank holding company subsidiaries and service corporations should be restricted from activities that they could dominate. This question of tie-in sales has been discussed and is not a hypothetical problem. It is a very real problem. And I would like to quote a couple of sentences from a special management bulletin published by the U.S. League of Savings Associations.

And I quote:

The Association's marginal tax rate is usually about 29 percent, whereas a service corporation's marginal tax rate is 46 percent. Service corporations thus should undertake activities that will reduce parent expenses.

I submit that this is not the provision of services on a more efficient basis but merely another loophole in the tax laws. Several examples showing that the coercion of buyers through discriminatory practices is not an idle threat are included in my statement. I would like to cite just one of them.

Iowa State banking institutions have been able to broker real estate for a number of years. A broker of western Iowa on the metropolitan board made several visits to southwest Iowa recently to assist one of his salespersons in listing a property. The client wanted to list but informed the salesperson that a banker in the community was also licensed and that the banker had informed the prospective client that financing would not be available if they listed with someone other than him. I refer you to the submitted statement for additional examples.

Not only is this type of action detrimental to the independent broker, but one question which has not been sufficiently addressed is the impact of this type of operation upon the underwriting policies of the bank. This would create a situation which would be very much akin to the insider loans which have been prohibited specifically. The insider would then be the service corporation with an affiliate of the loaning institution. Certainly, the experience of the 1920's that has been referred to earlier illustrates the dangers in this system.

Looking at the question of consolidation and weakening of the Federal regulators, one of the great strengths of our financial system is that we have a great diversity of institutions meeting different credit needs in the community. We think there must be some type of balance to keep the specialized institutions sufficiently competitive while still retaining their public purpose role.

We see further concentration of financial resources as harmful to independent small businesses. Banks could make credit availability or cost of credit contingent on the borrower's use of a broad use of the bank's hitherto restricted services. Control of essential business credit could go further from the communities.

When we see the current extent of unwise major loans by our money center banks to risky foreign clients, we are concerned that such loans could affect other industries the banks may become involved in. In this area we are looking for long-range solutions, and we are glad to see that the committee is, in fact, addressing the issue on the basis of the long-range soundness of our financial institutions rather than panicky solutions for short-term problems. And we certainly hope that that focus will continue.

Safety and soundness has historically been one of the most important goals of financial regulation. It is one element of public policy which should not be eliminated by the deregulation process.

As the ceilings on interest accounts are lifted and depository institutions compete by offering higher rates, they must also seek riskier, higher return assets. Therefore, the deposit insurance premiums must be flexible enough to reflect that institutions with higher cost of funds can be decidely riskier than more conservatively run institutions, as witnessed by the foreign loans referred to above.

The second major area that we would like to consider is what consideration should be given to the rapidly changing private financial services marketplace. Briefly, we would ask the question: Does the cross subsidization benefit the consumer in the long run when it provides an opportunity for predatory pricing to be used to drive competition out of business? The answer is obvious. Perhaps Congress should reexamine the antitrust laws in light of the priorities spelled out for mergers in the Garn-St Germain bill.

We believe that Congress should consider the dangers of economic concentration regardless of whether or not the institution is able to acquire a large pool of capital through special Government grant of powers or simply because of its own economic power.

FUTURE OF HOUSING CREDIT IN A DEREGULATION ENVIRONMENT

The last area we would like to mention is: What is the future of housing credit in a deregulated environment? This country's housing credit needs will be substantial for the rest of the decade: over a trillion and a half dollars. We look for the development of new financial instruments backed by mortgages that can compete for funds with other types of investments.

There are several unnecessary administrative- and legislative-imposed barriers. We all await with considerable interest the trust investment and mortgages program which is outlined in the President's budget, which, if effective, should address these problems by changing the laws governing the treatment of mortgage-backed securities. We believe that this committee should support this effort that is a vital component of this country's ability to thrive in a deregulated financial environment.

I appreciate the opportunity to make this statement to the committee.

[The complete statement follows:]

STATEMENT
of Donald H. Treadwell
on behalf of the
NATIONAL ASSOCIATION OF REALTORS
before the
SENATE SUBCOMMITTEE ON HOUSING
AND URBAN AFFAIRS

Mr. Chairman, my name is Donald Treadwell and I am a REALTOR from Detroit, Michigan and am President-elect of the Association. I am here on behalf of over 600,000 members of the NATIONAL ASSOCIATION OF REALTORS involved in every facet of real estate. I would like to thank you for this opportunity to comment on the current status of the financial services industry.

I am here to answer some questions and propose others that the committee should consider. The first is why should real estate brokers be interested in a legislative concept that essentially concerns financial institutions? Real estate brokers perform three basic functions for the public: a marketing function to find buyers for sellers, a technical function to lead buyers and sellers through the intricacies of transferring interest in real property and an advisory function to assist buyers in determining the availability of funds to close the transaction.

In the past the three functions have been simple as our financial system was based on local savings and loan associations and banks which accumulated funds from the local community and loaned them out to take care of the needs of local businessmen, consumers and homebuyers. Most funds to buy homes were raised, provided and administered by essentially local institutions and the homeowners themselves. This financial system which has enabled Americans to have the highest percentage of home ownership in the world is now being placed in jeopardy by some of the developments that are occuring or being proposed today.

I think this Committee must look at the three large issues involved here.

I. To what extent should those currently regulated federally insured and supported depository institutions be deregulated to compete with new forces emerging in the totally private marketplace?

II. Will the chain of events taking place in this private marketplace, resulting in economic concentration and potentially monopolistic situations be a healthy thing in the long run?

III. Will housing be able to compete for credit in this deregulated economy?

I. SHOULD CONGRESS FURTHER DEREGULATE FEDERAL FINANCIAL INSTITUTIONS?

In General, no.

While the NATIONAL ASSOCIATION OF REALTORS supports the overall goals of government deregulation we believe that the process should not place maximizing the goal of short run profits for depository institutions as the only public need served by our existing federally insured and supported financial institutions. This Committee should consider the long range availability of credit to individuals and businesses of all sizes and kinds in all sections of the country--in the small town and rural areas as well as the money center cities. This Committee should also consider the potentially harmful effects of precipitous deregulation, which would permit such anti-competitive practices as tying arrangements, cross subsidies, and uneven tax treatment. There have been tremendous changes in the marketplace wrought by new technology and consumer expectations; however, we urge you to remain objective and to exercise caution in any efforts to dismantle the present system that has served our country so well for almost 50 years.

Our current financial system has ably met many of this country's needs including: the fostering of home ownership at levels unmatched by any other nation; the availability of credit throughout the country that has made small businesses the bulwark of our economy; and a secure, sound financial system, which has regained the public confidence lost amid the disruption of the market in the 1920s. Even during recent troubled times for the thrift industry, public confidence remained firm. We are concerned that presumed efficiency and deregulation for their own sakes could negate the hard-earned results of our existing regulatory framework.

I will now comment on several issues raised by this Committee's timely oversight hearings on regulated financial institutions.

A. ROLE OF DEPOSIT INSURANCE/OTHER FEDERALLY SUPPORTED BENEFITS

Banks and thrifts serve many important public needs, and they do so with many advantages over those business entities they currently serve.

1. Federal Deposit Insurance

When a business needs capital, it must borrow these funds. Financial institutions borrow funds from depositors. These funds are in large part available because of federal deposit insurance. A cursory review of current advertisements for the Money Market Deposit Accounts underscores the important advantage of federal deposit insurance as a means of attracting depositors.

2. Favorable Tax Treatment

The tax treatment of federally chartered financial institutions also provides strong federal tax support that regular businesses do not enjoy. The bad debt reserve enables banks and thrift institutions to deduct additions to bad debt reserves over and above actual loan losses. Banks can deduct interest on obligations incurred to purchase tax-exempt securities, something regular taxpayers cannot do. Banks also pay little or no tax on foreign activities. Other preferential tax treatment includes special rules for loss carryovers and carrybacks, exemptions from restriction on commodity tax straddles, and special rules for loan foreclosures. These tax advantages can help explain why the effective U.S. tax rate on U.S. income for commercial banks in 1981 was 2.3 percent while the retailing industry tax rate was 22.7 percent.

3. Access to Special Credit

Access to credit from federal regulatory agencies such as advances from the Federal Home Loan Bank Board and the Federal Reserve's discount window also gives financial institutions an important tool not available to other businesses.

These federally supported benefits for depository institutions are very important to assure this nation of a stable and secure system of depository institutions. However, these benefits put them in a special class. Any changes to make these institutions competitors rather than resources for the commerce of this nation must take into account these benefits and a likelihood that they would provide unequal and unfair competition.

B. COMPETITION WITH FINANCIAL SERVICES INDUSTRY: DEREGULATION OF HOLDING COMPANIES, SERVICE CORPORATIONS

The **NATIONAL ASSOCIATION OF REALTORS** advises against deregulation of bank holding companies and their subsidiaries in areas that would irrevocably change the marketplace. While some entities could possibly compete with subsidiaries of federally insured depository institutions, the brokerage of real estate and other real estate services could not. We are concerned about the ability of the small businessman to compete on a level playing field. A bank holding company subsidiary decidedly has a clear competitive advantage over a local real estate broker, property manager, appraiser, or homebuilder that does not have a special relationship with a federally supported financial institution. Access to credit, after all, is the crux of our industry. For this reason alone, bank holding company subsidiaries and service corporations should be restricted from activities that they could dominate.

The nature of the relationship between a commercial enterprise and a financial institution could create anti-competitive situations. For example, service corporations are very effective tax management tools for their parent association that could lead to cross subsidies wrought by federal tax law. According to a "Special Management Bulletin" published by the U.S. League of Savings Associations on August 14, 1981, "The association's marginal tax rate is usually about 29%, whereas a service corporation's marginal tax rate is 46%. . . ." Mr. Chairman, the Bulletin then describes to thrifts how they can use this uneven tax treatment to their advantage. It says: "Service Corporations thus should undertake activities that will reduce parent expenses or generate income otherwise not available to the association." Further, this would seemingly allow service corporations to minimize profit margins to maximize the lower taxed parent institution's profit. This could create the situation where an independent small business could not compete with a service corporation that accepts lower profits due to the beneficial taxation of the parent institution, rather than any inherent efficiencies. There are no inherent advantages in claiming efficiencies when in reality these "efficiencies" are only another loophole in the tax law.

Further, the role of deposit insurance, the financial foundation of federally insured depository institutions, must be examined. The insuring funds were created to protect depositors, not bolster speculative ventures. Any change in the nature of the institutions benefitting from deposit insurance must follow this precept. Real estate activities can be a high risk business as the events of the past three years attest.

The potential for abuse is not limited to outright ownership. The NATIONAL ASSOCIATION OF REALTORS has been writing the FHLBB about a federal savings and loan in Lincoln, Nebraska that, without seeking prior FHLBB approval, entered into a contractual arrangement with a real estate brokerage firm. I am attaching copies or our correspondence in this case as well as providing local newspaper ads that will no doubt confuse the public and create anti-competitive situations.

I would also like to provide some cases supplied to us by the Iowa Association of Realtors . Iowa's state institutions have been able to broker real estate for years, and these problems have arisen:

- A broker in a western Iowa metropolitan board made several visits to southwest Iowa to assist one of his sales persons in listing a property. The client wanted to list, but informed the salesperson that a banker in the community was also licensed, and the banker had informed the prospective client that financing would not be available if they listed with someone other than him.
- A sales person with a firm in a western Iowa metropolitan board took a client into a Savings and Loan for a loan application. A vice president of the S&L called the buyer later in the day and said that before they could proceed on that particular house, that their trust department had some properties to show them.
- A Waterloo REALTOR had a house listed for several months. The sellers were several months behind in payments and could not come up with the money. While the listing was still in effect, the S&L who held the mortgage called on the sellers and said they were going to foreclose. However, they said they would give them an additional three months if they would list the property with them. The listing firm, not wanting to place the sellers in jeopardy, released them from the listing.

These cases from Iowa provide the foundation for our opposition to the entry into real estate brokerage by federally insured depository institutions.

C. CONSOLIDATION AND WEAKENING OF FEDERAL REGULATORS: LESS SPECIALIZATION, MORE CONGLOMERATION

The Congress will be considering proposals to merge the various financial regulators as the differences between types of financial institutions diminish. We would suggest that such a move would be detrimental and would reverse one of the great strengths of our financial system, that is a diversity of institutions meeting different credit needs in the community.

On the question of housing credit, the NATIONAL ASSOCIATION OF REALTORS wants to help keep the thrift industry in business specializing in the kind of lending that they do best. There must be a balance to keep specialized institutions sufficiently competitive while still retaining their public purpose role.

We are also concerned that consolidation of the federal insuring agencies may result in reinforcement of the current trend toward conglomeration at a time whem most small businessmen are struggling to emerge from the worst economic recession in years. The conglomeration and further concentration of financial resources can be harmful to independent small businesses as banks could make credit availability or cost contingent on the borrower's use of a broad range of the bank's hitherto restricted services. These entities will see the control over essential business credit go farther from their communities in the hands of larger institutions who may not feel any need to serve their credit needs. When we see the current extent of unwise major loans by our money center banks to risky, foreign clients, we are concerned that such loans could affect other industries the banks may become involved in.

By permitting groups like ours to raise such fundamental question's, your Committee, Mr. Chairman, demonstrates its concern for long range solutions. You are in fact addressing the issue of long range soundness of our financial institutions rather than panicky solutions to short-term problems.

It is also desirable to have a variety of sizes of institutions, not just large ones. These current problems created by international loans nearing default affects primarily the largest money center banks. Smaller banks, savings and loans, and other institutions do not have these concerns at present since they inherently have been in other lending areas. Therefore, heterogenity builds safety into our financial system.

The Assocation would oppose a reorganization of the federal regulatory agencies at the expense of adequate protection for individual depositors, as well as depository institutions themselves. "Safety and soundness" has historically been one of the most important goals of financial regulation. It is one element of public policy which should not be eliminated by the deregulation process. It will, therefore, be necessary to examine the current fixed-rate insurance premium for federally insured institutions. As the ceilings on interest on accounts are lifted and depository institutions compete by offering higher rates, they must also seek riskier higher return assets, and therefore, the insurance premiums must be flexible enough to reflect that institutions with higher costs of funds can be decidely riskier than more conservatively run institut~~ions.~~

II. WHAT NEEDS TO BE CONSIDERED WITH THE RAPIDLY CHANGING PRIVATE FINANCIAL SERVICES MARKETPLACE?

Mr. Chairman, the reason this Committee is holding hearings today is due to concern about how federally regulated institutions can compete with the totally unregulated players in the marketplace. We are somewhat concerned that this Committee has never really looked at the other side of this issue. That is, are the current rapid changes in American commerce good in the long run for consumers in general and the economy as a whole?

A. WILL FINANCIAL CONCENTRATION BRING SAVINGS AND EFFICIENCY TO CONSUMERS AND AT WHAT COST?

If two major commercial concerns in unrelated fields join forces and provide cross-subsidization of one business to boost another, is the public good being met? While a consumer who receives such a subsidy is clearly benefitted, what is the long run effect on the consumer in the long run who will face different market options in the future. One problem here is that through preda- tory pricing a conglomerate can drive out small independent businesses from a given region at will. This obviously is not healthy and therefore there are questions involved other than the direct cost savings to consumers.

B. SHOULD CONGRESS RE-EXAMINE ANTI-TRUST LAWS?

Just as the Congress amended our banking laws last year to reflect new market realities, it may be timely for a reexamination of anti-trust laws to allow them to function in the new world of high technology and fast money.

This issue may fall outside the jurisdiction of this Committee. If the Garn-St Germain bill spells out acquisition and merger priorities for regulated troubled institutions, should we not develop a similar pattern applying to anti-trust laws affecting acquisitions and mergers for non-regulated "banking" institutions?

We believe that the Congress should consider the dangers of economic concentration regardless of whether or not the institutions involved are federally chartered.

III. WHAT IS THE FUTURE OF HOUSING CREDIT IN A DEREGULATED ENVIRONMENT?

As the Nation's financial marketplace has changed, so must the dynamics of mortgage finance. Mortgage dollars will have to compete in this new environment with all other types of capital. This country's housing creding needs will be substantial for the rest of the decade--over 1.5 trillion dollars.

Perhaps the single most important factor in the ability of mortgage markets to meet this country's housing needs is the development of new financial instruments that can compete with corporate securities, stocks, and other investments in the nation's capital markets. Mortgage-backed securities enable investors unfamiliar with the business of mortgage lending to invest in familiar securities that, in fact, derive their income from the monthly payments of large "pools" or mortgages.

Unfortunately, there are barriers to the full development of mortgage-backed securites that diminish their competitiveness with other instruments; increase administrative costs of issuing these securities; and discourage new investors from the mortgage-backed security market.

We all await with considerable interest the Trust Investment in Mortgages (TIMS) program, as outlined in the President's budget, which, if effective, should address these problems by changing the laws governing the treatment of mortgage-backed securities. We believe that this Committee should support this effort as it is a vital component of this country's ability to thrive in a deregulated financial environment.

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NATIONAL ASSOCIATION OF REALTORS
Harley W. Snyder, President
Jack Carlson, Executive Vice President

Albert E. Abrahams, Senior Vice President, Government Affairs
Gil Thurm, Vice President & Legislative Counsel, Government Affairs

Government Affairs Division
777 14th Street, N.W., Washington, D.C. 20005
Telephone 202 383 1000

December 27, 1982

Richard T. Pratt, Chairman
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C.

Dear Chairman Pratt:

I am writing on behalf of the NATIONAL ASSOCIATION OF REALTORS® regarding a recent announcement by First Federal Savings and Loan of Lincoln, Nebraska, that it plans to acquire, through one of its service corporations, a real estate franchise.

On November 2, 1982 the Federal Home Loan Bank Board (FHLBB) withdrew its proposed regulation allowing the service corporations of federally chartered savings and loan associations to enter into "third-party" real estate brokerage on a pre-approved basis. This action responded to strong congressional sentiment that "pre-approved" service corporation activities be limited to the list approved by the FHLBB on April 12, 1981.

Although a regulation issued in the Spring of 1981 authorizes savings and loan service corporations to broker real estate for properties owned by the parent savings and loans, the service corporation, or a joint venture in which the service corporation participates, it does not authorize brokerage for property owned by third parties. To quote the regulation:

> "The Board proposed to authorize service corporations to provide real estate brokerage services for property owned by the parent association, the service corporation or a joint venture in which the service corporation participates. The Board expressly excluded property owned by third parties from its proposal. Several commenters suggested that the Board authorize service corporations to provide brokerage services for property owned by third parties without prior Board approval. Because of the potential conflict of interest that would arise each time an association was asked to finance the sale of real estate on which the service corporation would earn a brokerage commission, the Board has permitted real estate brokerage by service corporations only where the interests of the association and service corporation are substantially identical. The final amendments follow this

> policy and permit service corporations to provide real estate brokerage services only for property owned by an association which owns capital stock of the service corporation, the service corporation or a joint venture in which the service corporation participates.
>
> "However, the Board will consider applications for service corporations to provide real estate brokerage services for third parties on a case-by-case basis. Applicants must be prepared to demonstrate that such services will not conflict with sound underwriting practices on loans made by the association or the service corporation to finance sales of brokered property. Applicants may want to consider providing real estate brokerage services for property owned by third parties through a joint venture in which the service corporation holds a minority interest in order to mitigate the potential conflict of interest:"

We realize that First Federal could have applied for a case-by-case review of their application for permission to broker real state through their service corporation; but it is our understanding that no such approval has been given by the Bank Board. Has the First Federal Savings and Loan of Lincoln, Nebraska received permission for its service corporation to enter third-party real estate brokerage and if so for what reasons? Further, how many savings and loans to date have received permission for service corporation third-party real estate brokerage?

We would appreciate any assistance that you may provide to clarify this situation, and we look forward to your reply.

Sincerely,

Harley W. Snyder
President

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

Federal Home Loan Bank Board

RICHARD T. PRATT
CHAIRMAN

FEB 24 1983

Mr. Harley W. Snyder
President
National Association of
Realtors
Government Affairs Division
777 - 14th Street, N. W.
Washington, D. C. 20005

Re: First Federal Savings and
Loan Association of Lincoln
Lincoln, Nebraska

Dear Mr. Snyder:

This is in response to your letter of December 27, 1982, inquiring whether the Board has approved third party real estate brokerage activities for a service corporation of First Federal Savings and Loan Association of Lincoln, Lincoln, Nebraska ("First Federal") and for those of other Federal associations.

The Board regulation concerning service corporation activities, (12 C.F.R. § 545.9-1), provides the Board with authority to approve any service corporation that is reasonably related to the activities of a Federal savings and loan association. The Board has not chosen to approve an application authorizing a service corporation of First Federal or of any other Federal association to engage in third party real estate brokerage activities at this time.

Your letter also made reference to an announcement by First Federal that it planned to acquire a real estate franchise. In response to your inquiry, we contacted the management of First Federal. We were informed that none of First Federal's service corporations are providing third party brokerage services, but one has entered into an agreement to assist a real estate franchisor and its franchisees in expanding their activities in the

State of Nebraska. The assistance to be provided by First Federal's service corporations apparently is in the form of support services, not third party real estate brokerage activities. Moreover, First Federal is aware that its service corporations currently lack authority to engage in third party real estate brokerage activities and it has assured us that its service corporations are not engaged in such activities.

If I can be of further assistance, please let me know.

Sincerely,

Richard T. Pratt

Richard T. Pratt
Chairman

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Harley W. Snyder, President
Jack Carlson, Executive Vice President

Albert E. Abrahams, Senior Vice President, Government Affairs
Gil Thurm, Vice President & Legislative Counsel, Government Affairs

Government Affairs Division
777 14th Street, N.W., Washington, D.C. 20005
Telephone 202 383 1000

May 26, 1983

The Honorable Edwin J. Gray, Chairman
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20052

Dear Mr. Gray:

The NATIONAL ASSOCIATION OF REALTORS® is extremely concerned about the entry into real estate brokerage by federally insured depository institutions either directly or through service corporations. The Congress addressed this matter in the Garn-St Germain Depository Institutions Act of 1982 when it instructed the Federal Home Loan Bank Board to withdraw regulations that would have allowed unrestricted real estate brokerage by the service corporations of federal savings and loans. We are pleased to note that the Bank Board has done so.

We wrote former Chairman Pratt about this matter, and specifically about a federal savings and loan in Lincoln, Nebraska. Our staff has also had several discussions with Greg Smith of your legal staff. It appears that First Federal of Lincoln has entered into a contractual relationship with a real estate franchise without seeking any prior FHLBB approval. This partnership concerns us because the institution's linkage to the real estate brokerage service of the franchise can create confusion on the part of consumers that can make it extremely difficult for independent REALTORS® to compete with a savings and loan affiliated brokerage.

We are also concerned about potential conflicts of interest, tying arrangements and other possible abuses that can arise when savings and loans are allowed to compete with businesses they previously serviced.

Presently there are new developments almost daily in the area of financial services, and this requires greater diligence on the part of federal regulators to assure that the law of the land be upheld in the marketplace.

Thank you for looking into this matter and we look forward to your reply.

Sincerely,

Harley W. Snyder

ɒan Plans

al Estate Loans. First Federal Lincoln
; conventional, FHA and VA loans at
etitive rates for construction, pur-
: or refinancing of homes.

me Equity Loans. Borrow on the
y you have in your home for home
deling or other personal needs —
out disturbing the first mortgage.

RV Loans. The SURV (Supporting
n and Rural Revitalization) Program,
ned to assist low and moderate in-
: families in acquiring homes,
res an interest rate reduction for a
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me Improvement Loans. Borrow up
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ecial Home Aid Improvement Loans.
ı incentive for improving older
es in mature neighborhoods, this
al program allows you to borrow up
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mmercial Loans. First Federal Lin-
; experienced Commercial Lending
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ment buildings.

nsumer Loans. First Federal Lincoln
offers installment loans at com-
ve rates for automobiles, home im-
ments, personal needs and almost
ing else.

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Eliminates double mortgage payments by allowing Mid-America Partners to purchase your home at an agreed price, if it is not sold within a predetermined period.

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Gold Seal Property Program.
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Assures you of the services of highly qualified real estate counselors. Our licensed sales counselors are handpicked for their real estate expertise, then undergo extensive additional training before qualifying as a Mid-America Partners representative.

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ther one of the most complete finan-
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ıcial institution in the state. It's a
ıage that today includes interest-
ing checking accounts, high-yield
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consumer loans.

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oneyFund Investment.
ıe high-interest, short-term invest-
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ıey anytime without penalty.

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fully-insured, high-yield account that
vs you to write a maximum of 3
ks a month, or to withdraw funds in
on as often as you like, in any
ınt.

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Features First Federal Lincoln's low, 16% interest and no annual fee.

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The NATIONAL ASSOCIATION OF REALTORS® is comprised of more than 1,806 local boards of REALTORS® located in every state of the Union, the District of Columbia, and Puerto Rico. Combined membership of these boards is over 600,000 persons actively engaged in sales, brokerage, management, counselling, and appraisal of residential, commercial, industrial, recreational and farm real estate. The activities of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction and sales of condominiums. The Association has the largest membership of any association in the United States concerned with all facets of the real estate industry.

Elected Officers are: President Harley W. Snyder, Valparaiso, Indiana; President-elect Donald H. Treadwell, Sr., Southgate, Michigan; First Vice President David Roberts, Mobile, Alabama; Treasurer Budd Krones, Tucson, Arizona.

The Chief Administrative Officer is Jack Carlson, Executive Vice President and Chief Economist.

The Senior Vice President, Government Affairs is Albert E. Abrahams and the Vice President and Legislative Counsel, Government Affairs is Gil Thurm.

Headquarters of the Association are at 430 North Michigan Avenue, Chicago, Illinois 60611. The Washington Office is located at 777 14th Street, N.W., Washington, D.C. 20005. Telephone (202) 383-1000.

REALTOR®

Senator HEINZ. Thank you, Mr. Treadwell. Mr. Gilman.

STATEMENT OF MARVIN S. GILMAN, CHAIRMAN OF THE MORTGAGE FINANCE COMMITTEE, NATIONAL ASSOCIATION OF HOMEBUILDERS

Mr. GILMAN. Senator Heinz, my name is Marvin S. Gilman, I am a homebuilder and developer from Wilmington, Del. I am testifying here today on behalf of the more than 111,000 members of the National Association of Homebuilders, inasmuch as I am chairman of its mortgage finance committee.

NAHB is the trade association of the Nation's homebuilding business. Accompanying me this morning are Mr. Larry D. McBennett, assistant legislative counsel of the association, and Ms. Elizabeth B. Qutb NAHO's staff vice president for mortgage finance.

I am pleased to be here to testify on the domestic financial services industry. In particular, I would like to address the impact of housing finance needs on several proposals for change in the financial services industry.

I have a 28-page prepared statement. People who know me well would feel perhaps that it would be quicker if I read it than if I summarized it, but I'll take my chances and submit it for the record, and try to summarize.

We in the homebuilding industry are cautiously optimistic at the moment about the current housing recovery. Economic signs are positive to date.

Housing starts for the first 4 months of 1983 were at an annual rate of 1.65 million, yet it is too soon to gage the long-term strength of the recovery, because of its fragility due to the uncertainties about interest rates and the prospect of large Federal budget deficits.

I also would like to make a comment about the role of HUD in this matter. Traditionally, it has been HUD's role to lead interest rates on the way down and to lag when interest rates move up. We hope that this is recognized by the current administration and by HUD and that the recent increase in the FHA interest rate will prove to be an aberration.

As we look at the future of the housing industry in the context of the changes in the financial services industry, NAHB wants to insure that credit will be available to the home buyer and the small businessman at rates they can afford. Parenthetically, it has always struck me that one of the nice things about being a homebuilder is that we are normally on the side of the angels. What's good for homebuilding is good for the economy. What's good for homebuilding is good for the home buyer.

We are presently looking to a number of sources for mortgage credit in the future. Traditional lenders will probably continue to originate residential mortgages, but will be more likely to resell them on the capital markets.

Logic tells us that portfolio lending appears more and more risky at present because of the volatility of interest rates. But "it ain't necessarily so." I don't know of any group that has a shorter memory than bankers at thrift institutions who find their deposits swelling. For this reason, long-term fixed mortgages continue to be viable. In addition, they are viable because consumers want them and because originating lenders can sell them on the secondary mortgage markets.

The Federal Government and State governments too, will continue to have an important role in providing assistance to those who cannot look to the conventional market to for adequate service. In particular, aid will still be necessary for those of low and moderate income, as well as for first-time homebuyers and for the elderly. HUD programs, as well as State and local mortgage revenue bonds are responsible for the provision of adequate housing for millions of Americans.

The secondary mortgage market is fast becoming the cornerstone of residential mortgage finance. This trend is likely to continue well into the future. FNMA, FHLMC, and GNMA attract billions of dollars in investments to housing. Fannie Mae and Ginnie Mae also play an important role in balancing the cycles in the housing industry. Any efforts to change their quasi-agency status should be resisted because of their fundamental importance to future housing finance.

We believe the private entities can indeed enter the huge secondary mortgage market and compete effectively, especially when the TIM's proposal and other innovations increase the attractiveness of mortgage-backed securities to the investment community.

At the same time it is necessary that Congress give its attention to raising the mortgage limits for Fannie Mae and Freddie Mac loans, so that those persons who live in areas that have higher costs are not penalized in having to pay higher prices for their mortgage loans.

Trusts for investments in mortgages, TIM's, offers a means for eliminating the major tax, legal and regulatory obstacles in the way of conventional mortgage-backed securities. TIM's should indeed correct existing problems with repayments and investment terms that create uncertainty for the investor. We support the concept of TIM's and hope Congress will give it thorough consideration as soon as the proposal is formally made.

But one word of caution: The adoption of TIM's should be an additional tool, not a substitute tool. Fannie Mae, Ginnie Mae, and Freddie Mac must be kept strong and their agency status preserved. TIM's cannot be a substitute for the function these organizations provide, in bad times as well as good.

BUILDER BONDS

As many of you are, I'm sure, aware, larger homebuilders in this country are beginning to issue their own taxable bonds, using mortgages as security. These builder bonds offer a promising vehicle for larger builders, not only because they raise mortgage funds, but because they lower the builders' costs of operating capital.

Smaller builders can make use of builder bonds by forming cooperative issuing groups, which I'll discuss in a moment, or by making special arrangements with established lenders.

To help boost the use of these bonds we recommend that Congress remove the current limitation on Fannie Mae's ability to make loans on the security of mortgages.

We believe more funds can be attracted to home financing from pension funds, as well as individual and foreign investors.

Pension funds would invest more if conventional mortgage-backed securities were given an investment rating by rating agencies such as Standard & Poor's and were exempted from prohibited transaction rules.

Representatives Gephardt and Wyden have introduced H.R. 1418 which we endorse. This act would make the changes needed as well as make uniform reliable mortgage investments possible for pensions.

Retail offerings using mortgage pools and unit investment trusts have helped small individual investors invest in housing, and as an example, I'd like to point with pride to the home investors' fund established by NAHB and the National Association of Realtors.

It's a new mutual fund suitable for the long-term savings of small investors. It is the first such fund authorized to invest in mortgage-backed securities other than Ginnie Maes.

Foreign investors, too, are a huge potential source of funds for real estate investment. Congress should review ways to make foreign investment more attractive and practical to them under our tax laws.

NAHB is also innovating in another aspect in order to attract capital to housing. We started HOMAC, the Home Mortgage Access Corporation, to aggregate builder demand for mortgage finance and to enable builders to negotiate with secondary market entities at favorable terms and at favorable rates which, in turn, could be passed on to the homebuyer. HOMAC has brought competitive financing to areas where there has been none.

We are concerned, however, about certain trends in the financial services industry. The Vice President's Task Force on Regulation of Financial Services is reviewing the entire Federal regulatory structure for financial institutions. The task group will make legislative proposals which we hope will call for beneficial reforms that will reduce the burdens of the current structure.

However, we would oppose any move as part of that effort which went toward decentralization of the financial regulatory agencies. We believe that a central Federal bureaucracy will diminish innovation and will not enhance the provision of credit for the full range of housing and other needs.

We also view the rapid consolidation of the financial services industry into larger institutions as harmful to the delivery of credit to small business. To date the deregulation that assisted the consolidation of financial institutions has focused on how banks and thrifts aggregate capital, but not on how they use the funds.

Our country has progressed very well over the last 50 years based on a national policy which has encouraged homeownership. We do not believe that any move which changes this national policy is in the national interest. We do not believe that bigger banks are necessarily more efficient or even more profitable than smaller banks.

Homebuilding is essentially a local enterprise. Even with the latest technological advances, large banks are not in a position to evaluate a new buyer such as a first-time home buyer—my children, your children—as well as can be done by the local lenders who know the people and work with them on a personal basis.

Community-based lending is needed to make lending responsive to the multiple needs found throughout the Nation.

Lastly, we are adamantly opposed to the expansion of banks and thrifts into direct real estate investment. Their competition with small independent builders and land developers will be inherently unequal and unfair. In addition, past history has shown that they often do not know what they are doing and will likely incur huge losses, and will once again need to be "bailed out".

The only reason that homebuilders are rightfully concerned with the profitability of big banks is not because we're their stockholders, but we abhor the thought of homebuilding and real estate to getting a bad name.

The entry of banks and thrifts into the real estate business will prompt anticompetitive actions against their small competitors. Vertical integration of the industry is a likely outcome of their expansion and will reduce competition both in the short and the long runs.

We recommend that the healthy wall between financing and real estate commerce be kept intact. In considering the future of the financial sevices industry, it is important that we keep people and not just institutions uppermost in our minds.

Whether we are a home buyer, a small businessman or just part of the American public in general, we are all the customers of and the justification for the financial services industry.

Thank you very much for this opportunity to present our views. I'd be glad to try to answer any questions you may have.

[The complete statement follows:]

STATEMENT OF

THE NATIONAL ASSOCIATION OF HOME BUILDERS (NAHB)

before

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

on

THE FINANCIAL SERVICES INDUSTRY

on

June 16, 1983

Mr. Chairman and Members of the Committee:

My name is Marvin S. Gilman and I am a homebuilder and developer from Wilmington, Delaware. I am testifying on behalf of the more than 111,000 members of the National Association of Home Builders, of which I am Chairman of the Mortgage Finance Committee. NAHB is a trade association of the nation's homebuilding industry. I am pleased to be here to testify on the domestic financial services industry. In particular, I would like to address the impact of housing finance needs and several proposals for change in the financial services industry.

STATUS OF THE HOUSING INDUSTRY/OUTLOOK

The housing recovery has received much attention recently as one of the bright spots in the economic picture. All indications show a substantial improvement in housing. Building activity is up dramatically. If interest rates decline, housing should have at least two good years. Future years' prospects are more uncertain because of projections for enormous federal budget deficits.

HOUSING PRODUCTION

New housing production in 1982 totalied 1.07 million units, the lowest since 1946. Housing starts in the first four months of 1983, however, soared to the 1.65 million level. Based on NAHB's most recent econometric forecast, total housing production is expected to increase to 1.55 million units in 1983.

NEW HOME SALES

While 1982 was the worst year for new home sales since the Census Bureau began collecting statistics in 1963, sales of new homes in the first four months of 1983 were up 60% from the same period a year ago. The average seasonally adjusted sales rate for the first four months of 1983 was 593,000.

INTEREST RATES

Conventional mortgage interest rates moved upward in recent weeks and now average 13 percent. Although mortgage interest rates were much higher last year, they are still high by historical standards and incomes needed to afford housing are still beyond the reach of many potential homeowners. The continuation of rates at current or, even worse, higher levels poses a threat to the housing recovery.

UNEMPLOYMENT

Unemployment in the construction trades in May was 20.4%, up from 20.3% in April. The rate is more than twice as high as the rate of unemployment in the overall economy. The construction trades unemployment has been above 20% for 10 of the past 11 months.

Regardless of the levels of production in the 1980's, changes are occurring in the housing product and the structure of the building industry. These changes will continue. The average size of a new single family home increased from 912 square feet in 1950 to a peak of 1,655 square feet in 1978. In 1981 it dropped to 1,550 square feet. However, that doesn't tell the whole story.

Major builders in particular are downsizing single family units by 300 to 500 square feet and townhouses by 200 to 300 square feet. This is no longer a gradual decline, but a major change.

The reasons are obvious: smaller families, increased land and building costs, higher utility bills, higher interest rates, and fewer children. Smaller sizes have meant fewer bedrooms, fewer bathrooms, and the change from expensive basements to slab construction.

Additionally, land costs and demographics are increasing the popularity of townhouses, zero-lot-line units and cluster developments. Greater density helps consumers reduce land costs.

Just as unit types are changing, the structure of the industry itself is likely to change during the 1980's. The prolonged housing slump has induced the typical builder of speculative single family units to diversify into custom homes, condominiums, land development, remodeling and commercial buildings. Diversification is likely to continue as builders try to protect themselves against the cyclical swings of the homebuilding market.

Large volume and small custom builders will probably face the fewest problems competing in the market in the 1980's. Middle sized builders (from 25 to 250 units) are under severe pressure to remain competitive because of problems with access to affordable mortgage credit.

HOUSING AND CREDIT

Technological and economic changes are propelling a wave of consolidation, deregulation and innovation in the financial services industry. NAHB wants to ensure that the changes in the financial marketplace lead to a strengthened mortgage finance system. We want the American homebuyer to have access to mortgage money at rates and on terms that he or she can afford. We want the small businessman, such as the homebuilder, to have access to credit at competitive rates.

At present, the American homebuyer is under attack by those who say that too much credit is flowing into housing investment. That notion ignores the facts. Over the past 30 years, the total share of the nation's credit devoted to mortgages has been dropping steadily. Federal Reserve Board data show that residential mortgages consumed 31% of available credit in the 1950's, 25% in the 1960's and 70's, and 17.5% from 1980-1982. A national policy of providing favorable credit and tax treatment for housing has been good for the American people and good for the American economy. It has paid rich dividends, opening the doors to homeownership for millions of Americans and giving the average working man a stake and a sense of pride in this democratic society. The industry has been a driving force behind the economic progress of the last four decades, providing jobs for millions and generating demand for thousands of goods and services throughout the economy. We feel it is essential to restore and maintain that priority.

I want to address two broad questions. What are we looking to as the sources and vehicles for the provision of mortgage finance in the evolving marketplace? What legislative and regulatory changes being proposed would assist or pose a threat to the provision of mortgage finance?

PRIMARY MORTGAGE MARKET

Since World War II the nation has had a policy of fostering homeownership. To that end we have enacted favorable tax laws, developed the thrift industry specifically to provide home financing, and extended federal and state assistance to homebuyers of modest incomes as well as housing for those unable to afford home purchases. The national commitment to housing and the highly competitive homebuilding industry have given the American people an array of choices and means to attain the American dream.

In recent years, thrifts have been joined in the primary market by commercial banks and mortgage bankers. For most borrowers these companies are the visible source of home finance. For the first quarter of 1983, the U.S. Department of Housing and Urban Development reports that savings and loans originated 37.7% of total dollar volume of the mortgage loans for 1-4 family non-farm homes. Mortgage bankers originated 31.7%, commercial banks 22.7%, and mutual savings banks 4.6%. These institutions will continue to be the primary originators of mortgages, even though they increasingly are not the final investors.

Federal and state programs will continue to play a role for special segments of the population. For example, the rural housing programs administered by the Farmers Home Administration have played a major role in delivering housing to rural areas. Since 1949 rural housing programs have extended over 1.7 million individual housing loans totaling over $30.5 billion. Programs of HUD and mortgage revenue bond programs of state and local governments are also responsible for the provision of adequate housing to millions of

Americans, who without these programs would not be able to afford decent housing. Since interest rates are expected to remain high by historical standards, these programs should continue to be available to assist Americans trying to obtain decent shelter.

SECONDARY MORTGAGE MARKET

The secondary mortgage market has become the cornerstone of the entire residential mortgage finance system in America. The Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Government National Mortgage Association (GNMA) provide liquidity to primary mortgage lenders. They attract enormous investment from the capital markets into housing. The sheer volume illustrates their importance to the national system of housing finance. FNMA currently holds $74 billion in mortgages, roughly 1 out of every 20 mortgages. By the end of February 1983, FHLMC had issued $49.5 billion in Participation Certificates in its mortgage backed securities program. GNMA in turn had guaranteed over $138 billion in mortgage-backed securities by the end of 1982. Last year over one-half of all mortgages originated were sold in the secondary market.

The Federally-sponsored agencies are extremely important for the counter-cyclical role they play in the housing markets. They cushion the downward swings of the housing industry by sustaining a flow of funds. As a result of these agencies' efforts, mortgage money remained available -- albeit expensive -- throughout the interest rate cycle. Many builders and lenders give credit to these entities for pulling them through the recession.

The existing secondary market entities will have to be even more vigorous to meet the heavy demand for mortgage money during the 1980s, as the postwar baby boom generation continues to enter the housing market. The demand for mortgage originations during the remainder of the decade has been estimated by FNMA at approximately $1.6 trillion. By 1990, the share of mortgages sold on the secondary market is expected to increase to between two-thirds and three-fourths of the total.

This phenomenal anticipated demand for mortgage credit coupled with the decline of thrifts as portfolio lenders is dramatically increasing the importance of the secondary mortgage market for housing finance. Secondary mortgage market entities are in turn relying more and more on mortgage-backed securities to attract a variety of investors. Mortgage-backed securities are uniform investment vehicles that capital market investors can evaluate and compare to other investments. Their terms can be tailored to meet different investment needs.

The President's Commission on Housing recognized the importance of mortgage-backed securities (MBS's) and pointed out that the conventional MBS's are subject to legal, regulatory and tax disadvantages vis a vis corporate debt obligations. Some of the obstacles have been removed, but others remain. In particular, it is crucial to find a means of protecting investors against prepayments and to allow active management of mortgage loan pools that back the MBS's. FHLMC has found one answer. Last week it issued $1 billion in Collateralized Mortgage Obligations (CMO's). FHLMC is guaranteeing the minimum repayment schedule and has divided the CMO's into three classes with different terms.

Our estimate of the size of the mortgage-backed securities market makes us welcome the entry of private entities into that market. General Electric Credit Corporation, the Residential Funding Corporation and others are ready to or beginning to serve a portion of the mortgage market. Thus far they have concentrated almost entirely on the upper end of the mortgage market. We believe they are pricing higher than they need to price. Competition would lower their charges and the price of home finance. To increase competition and to help provide better secondary market service to the upper end of the mortgage market, we urge Congress to raise the mortgage loan purchase limits of FNMA and FHLMC. An increae in the limits parallel to FHA high cost areas would let FNMA and FHLMC serve housing being built in markets having higher costs better. It would not threaten the emergence of the private secondary market. The conventional mortgage finance system will need strong participation by both the agencies and their newer private competitors.

The efforts of the private secondary market entities should complement those of FNMA, FHLMC, and GNMA. The latter provide national coverage and uniformity that the private entities cannot achieve. The private entities also cannot be counted on to play the countercyclical role of the federally-sponsored agencies. The agencies have provided essential support to housing in both good times and bad. Their presence in the market in down years keeps open sources of funds and has kept many builders in business. We believe the agency status of the federally-sponsored agencies should be retained. No one is presently able to perform the functions of FNMA and FHLMC should they be forced to become private.

TRUSTS FOR INVESTMENTS IN MORTGAGES (TIMs)

The TIMs concept was presented in the final report of the President's Commission on Housing which contained specific recommendations on eliminating statutory and regulatory barriers to the increased use of conventional mortgage-backed securities. Conventional securities are those backed by mortgages not insured by the Federal Housing Administration nor guaranteed by the Veterans Administration.

A number of regulatory actions have been completed, notably granting eligibility of such securities for simplified shelf registration procedures of the Securities and Exchange Commission. Legislation is needed to correct problems with the grantor trust, the existing sale of assets tax mechanism used to pool mortgages and package them into securities. For example, if a mortgage is prepaid, under existing law the trustee must immediately pass all principal and interest payments through to the security holder. The funds can not be reinvested or retained to pay the investor according to a predetermined payment schedule. Because prepayment rates vary widely with economic and interest rate cycles, they create a high degree of uncertainty, raising an investor's yield requirements and driving up the interest rate on the underlying mortgages.

The legislation should be structured to accommodate a broad range of mortgage security instruments, including those initially sold at a discount to increase returns above nominal yields ("original issue discount") and those that are broken down into two or more classes of certificate holders with varying claims to the security's cash flow (e.g., "slow pay -- fast pay"). The latter feature would allow investment bankers to structure securities so as to be able to sell an appropriate portion of each pool of mortgages to individuals, financial institutions and pension funds. FHLMC's use of this multiple maturity structure with its Collateralized Mortgage Obligations produced a 0.625% reduction in the mortgage rate. That was enough to qualify one million more households. However, it is a debt structure, and FHLMC's ability to issue debt is limited. We need this flexibility in a "sale of assets" framework. The ability to adjust cash flows and maturities would also provide flexibility in responding to shifts in interest rates.

Currently, conventional mortgage-backed securities are created through complex layering of transactions and costly regulatory compliance. Adoption of TIMs would simplify the packaging of mortgage-backed securities, lower their cost of issuance, allow the market to establish uniform instruments, and thereby, hopefully, reduce the cost of mortgage money obtained in the secondary market.

BUILDER BONDS

The cash flow or builder-backed bond is a recent innovation which is attracting considerable attention within the industry. It is a borrowing which is collateralized by the cash flow from a pool of mortgages, rather than by the general corporate assets of the issuer. The mortgages are originated and held by a single purpose financing subsidiary which enters into a trust indenture with a third entity that issues the bond. An independent trustee receives the payment stream from the collateral, maintains an escrow account, and makes periodic payments to the bond holders.

Builder bonds are being issued within the existing statutory framework. The real significance of this program is that it lowers the builder's cost of operating capital substantially. For some the reduction has been from the traditional level of the prime plus two percent to something in the range of five percent. Lower cost financing coupled with enhanced cash flow allows a builder to lower home prices, buy down interest rates to affordable levels, and expand operations more rapidly to meet increasing consumer demand.

To date most builder bonds have been created by having a single large builder's mortgage banking subsidiary originate FHA/VA mortgages, pool them as GNMA securities and place the Ginnie Maes in another special subsidiary (such as RYMAC - Ryan Mortgage Acceptance Corporation) which then issues AAA-rated corporate bonds collateralized by the Ginnie Maes. In order for smaller builders to receive these important benefits, they will probably have to form cooperative issuing groups and/or make special agency arrangements with established lenders for originating mortgages and either issuing Ginnie Maes or pooling conventional mortgages. Many knowledgeable industry analysts feel that the continued competitiveness of the local tract builder vis a vis the large national public companies will be materially affected by the outcome of this endeavor. Thus it appears that there are important issues of market structures and consumer choice at stake. At our January Convention, NAHB adopted a resolution in support of multibuilder bonds and pledged to work actively to assist in overcoming any regulatory and legal obstacles that might inhibit necessary departures from traditional structure and practice. The only related legislative change we are seeking at this time to aid with the use of builder bonds is more flexible authority for FNMA to make loans on the security of mortgages.

PENSION FUNDS, RETAIL AND FOREIGN INVESTORS

Pension Funds

While pension fund assets have grown in recent years to the point where they now constitute the largest single capital pool in our economy, they have been largely absent from the trillion dollar plus residential mortgage market. Increasing pension investments in mortgages will increase the flow of funds into the secondary market, bring interest rates down to affordable levels, and reduce the severity of housing cycles which have a major influence on the overall performance of our national economy.

Substantial progress has been made in opening up state-regulated public employees funds and the ERISA-regulated, multi-employer plans, especially those of the building and construction trade unions. According to the last annual survey of the portfolios of the 200 largest pension funds published by Pension and Investment Age, these major funds increased their investments in residential mortgages from one percent to four percent of total assets during the year ending in September 1982. Union and public employer funds led this effort, increasing their investments to 8 percent and 7.5 percent respectively. Corporate funds were unchanged at one percent.

Corporate pension funds remain outside the mortgage market because of indifference and unnecessarily restrictive regulations issued by the Department of Labor. The Department has had great difficulty understanding the nature of the secondary mortgage market, and has not accepted the fact that the series of contractual and fiduciary relationships created by appraising a home, underwriting a loan, insuring a mortgage, and rating a mortgage pool make mortgage investment a highly regulated and safe business. As a result, the Department's interpretations of ERISA place extra burdens on fund managers and trustees investing in mortgages that do not apply to other types of investments.

NAHB first applied for a mortgage class exemption from the prohibited transactions provisions of ERISA in June, 1980. A badly flawed exemption was finally issued in May, 1982. The underlying problem here is that the Labor Department is developing regulations which substitute its judgment of what constitutes a good investment for the discretion more properly belonging to the fund trustees and managers under the general prudent man standard.

Legislation was introduced in the last Congress by Representatives Gephardt and Wyden to correct the problems with Prohibited Transactions Exemption 8287. The bill, which has been reintroduced this year as HR 1418, includes both government supported and conventional multifamily mortgages within the definition of a recognized mortgage loan eligible to be purchased. The existing restriction of eligibility to loans which can be purchased by GNMA, FNMA or FHLMC precludes funds from acquiring so-called non-conforming, conventional loans, which resemble eligible mortgages except for the fact that they exceed the FNMA/FHLMC statutory limit of $108,300. This limit has a severe impact in California and other high cost housing markets and effectively precludes pension funds from participating in the most lucrative part of the market. While the Labor Department has talked repeatedly of amending the class exemption on these points, we have not seen any formal action.

A revised version of the current legislative proposal includes an exemption for conventional mortgage-backed securities given an investment grade by a national rating service. Standard and Poors has rated mortgage securities for some time and Moody's is currently establishing a new division to rate both pass-through and cash flow mortgage securities. Put another way, if a pension fund manager can meet his fiduciary responsibility by relying on a corporate bond rating, he should also be able to rely on a similar rating for a mortgage-backed security.

Last year, considerable criticism appeared in the pension press to the effect that NAHB wanted to do away with any role for an independent fiduciary. The revised Gephardt-Wyden bill retains this requirement for mortgages which are not eligible for purchase by a federally-related agency or included in a rated mortgage-backed security.

Retail Investors

The relatively large minimum purchase size of mortgage-backed securities has limited their market primarily to financial institutions and institutional investors. In recent months two new mutual funds, registered under the Investment Company Act of 1940, have been established to appeal to the retail or individual investor.

Last month NAHB joined with the National Association of Realtors to sponsor the Home Investors Fund, a no-load mutual fund for conventional mortgage-backed securities. It is described below in more detail.

Merrill Lynch has also moved into this area with a series of unit investment trusts collateralized by GNMA securities or more recently by a pool of mortgage cash flow bonds. Merrill Lynch plans to collect GNMA mortgage-backed bond packages from builders around the country on a monthly basis and aggregate them into standard instruments conforming to an SEC shelf registration.

No governmental action is needed at the present time with respect to mutual funds or unit investment trusts. The SEC staff is currently educating itself on the peculiarities of mortgage-backed securities and the investment companies need time to market this new product to the public.

The mutual fund format allows the issuer to include some of the features proposed for TIMs, but is not as efficient as a TIMs in that the underlying mortgages must first be packaged as securities and then repackaged as a fund. TIMs could purchase mortgages directly.

NAHB believes the potential retail market for mortgage-backed instruments is substantial during periods of economic stability. Merrill Lynch reports daily sales between $25-30 million recently, which is an $8 billion annual rate. However, this market dries up whenever short-term rates rise above long-term rates, and therefore it tends to exacerbate cycles.

Nonetheless, we must continue our efforts to bring individual investors into the secondary market. Their federally-insured savings deposits were the traditional source of mortgage finance. Today they can substitute federally-backed mortgage pools with no loss in safety. However, we need a stable interest rate environment that encourages long-term capital formation.

Foreign Investors

FNMA and GNMA are looking toward the multi-billion Euro-dollar market as a major new source of funds for housing. Banks and corporations have tapped this market for funds for years, but housing has not had access. As the disruptions in the domestic capital markets caused by deregulation subside and new investment vehicles become firmly established, the next step is to achieve more effective integration of housing finance into world capital markets.

Real estate has always been a preferred investment in Europe and the overall strength of the American economy provides protection against political unrest and currency devaluations.

The biggest barrier to foreign investment in residential real estate is Section 1441 of the Internal Revenue Code which provides for a 30 percent withholding rate on all non-wage income payable to nonresident alien individuals, foreign partnerships or foreign corporations. The filing and refund procedures of the Internal Revenue Service for nonresident alien taxpayers are notoriously complex and lengthy.

Two approaches should be explored to deal with this problem. The first is to simplify and streamline the existing provisions governing foreign taxpayers. The other would build on the concept contained in legislation introduced by Senator Bentsen. Under his bill S. 519, tax exempt funds that invest in residential mortgages in the United States would be exempt from U.S. taxation or withholding. This treatment could be extended on a reciprocal basis to other entities that were tax-exempt under their respective national laws.

The long-term impact of such changes is difficult to determine, but even a small percentage of a capital pool of hundreds of billions of dollars would significantly increase the supply of money in the mortgage markets.

NAHB INNOVATIONS

Home Investors Fund

In May, 1983 NAHB joined with the National Association of Realtors in cosponsoring the Home Investors Fund (HIF), a no-load open-ended mutual fund suitable for IRAs, Keoghs and other long-term savings. The Fund is administered by the Vanguard Group and the portfolio is managed by Wellington Management. The model portfolio, which consists of 20 percent each in GNMAs, FNMAs and FHLMCs and approximately 35 percent in conventional securities, has a current gross yield of 12 percent. Operating expenses are running near the permissible legal limit of 1.5 percent to produce a net yield of about 10.5. As we move out of the start up period, the net should rise to somewhere around 11 percent.

Initial marketing has been directed to the 700,000 plus members of NAHB and NAR. We are asking our members to place a portion of their retirement savings, especially their IRA and Keogh accounts, in the fund in order to earn an attractive return, invest in the future of their industry, and demonstrate the long-term viability of conventional mortgage-backed securities as an investment.

Between the initial announcement on May 2 and June 3 the Fund attracted $2 million in funds. It offers professional management and small investment minimums and thus is appropriate for smaller institutional investors as well as individuals. HIF is the first such fund authorized to invest in MBS's other than Ginnie Maes and hopes to play a pioneering role in promoting market acceptability for a broad range of investment grade mortgage securities. It also gives members of the housing community an opportunity to support their own industry.

Home Mortgage Access Corporation

The Home Mortgage Access Corporation (HOMAC) was created in September, 1982 as a wholly-owned subsidiary of NAHB. Its purpose is to aggregate builder demand for mortgage finance and negotiate directly with secondary market entities for commitments at the most favorable rates and terms possible. HOMAC has so far sold FNMA and FHLMC commitments totalling over $250 million and recently sold $180 million in FHA/VA coverage obtained through four mortgage banking companies. In the near future HOMAC hopes to offer a GNMA-backed builder bond and a private MBS for jumbo mortgages.

HOMAC has been successful in bringing competitive financing to areas where there was none and in obtaining terms and pricing especially suitable to builders. It has helped to fill the gap left by the disappearance of local portfolio lenders from the market and is also positioning itself to assist the mid-sized local builder compete with the large national firms. HOMAC has enrolled over 1,400 members and plans to convert to a shareholder-owned mutual corporation within the next six months.

HOMAC represents an important trend. The market is becoming increasingly national in scope with lenders pricing and selling their product through Wall Street which also aggregates savings on a grand scale. This creates a need for new intermediaries which can tap the capital market for the prospective homebuyer. Mortgage bankers have a head start in this area and have seen their market share grow. However, as market concentration increases, there is a continued need for smaller participants to either merge or organize collectively to bargain with the "megalenders" who emerge.

REFORM OF FINANCIAL REGULATORY AGENCIES

The Vice President's Task Group on Regulation of Financial Services is reviewing the Federal regulatory structure for financial institutions with the intent of proposing legislative changes. The Task Group has identified problems with the current structure. They include, among others, differential treatment, excessive regulatory controls, duplication, and agency unresponsiveness.

NAHB supports beneficial reforms that reduce the burdens of the regulatory structures. Those reforms should be approached cautiously. Our financial regulatory agencies should be molded so that they provide even better support to the financial institutions that serve the diverse credit needs of the public. The current system has produced the best housed nation in the world. It has done so because the nation has placed a priority on homeownership, in part through the establishment of federally insured thrift institutions dedicated to meeting home finance needs. Reorganization in the name of efficiency should not be allowed to threaten the national commitment to homeownership.

NAHB does not support the homogenization of the federal regulatory institutions. One or a few bigger, more powerful, centralized Federal regulatory institutions would lend themselves to arbitrary decisions, rigidity, uniformity in the provision of financial services, and the demise of the dual banking system. Innovation in financial services and provision for the full range of credit needs are to be found in diverse institutions and not in a centralized Federal bureaucracy, dominated by the concerns of the nation's largest banks.

CONSOLIDATION OF FINANCIAL INSTITUTIONS

The continuing consolidation of the financial industry, accomplished through the growth of branch banks and multibank holding companies, forces small businesses to compete against large corporations, the federal government and foreign countries in their quest for capital. The home building industry is made up of tens of thousands of small community-based businesses. Three quarters of all home builders build fewer than 25 homes per year. These small businesses depend heavily on community-based lenders for project financing. The revolution in the financial service industry threatens to replace the neighborhood bank with an automatic teller machine.

We disagree with the testimony before this Committee on June 8 by Assistant Attorney General William F. Baxter. He advocated the repeal of the McFadden Act and the Douglas Amendment that restrict interstate branching by national banks. Mr. Baxter asserted that interstate branching would not harm small, local banks. Rapid repeal would help them, he claimed, because it would enable national banks to buy them out at a premium. Mr. Baxter and presumably the Department of Justice for which he speaks appear unable to conceive that banks serve some purpose beyond the enrichment of their officers and their shareholders. What will happen when the small locally based institutions have disappeared and their deposits have been transferred to financial centers such as New York? Will a loan request by a young builder wanting to build two houses or a businessman trying to start a local clothing store have be evaluated under national bank standards set in New York City? Or will the New York bank refuse to consider small loans as too expensive to process? The realization of this vision of the future will not serve us well.

It is a sad truth that, to date, deregulation has focused on how banks and thrifts aggregate capital, not how they use the funds. The large financial institutions are developing ever more efficient ways to collect funds throughout the nation. They say nothing about how, or where, they plan to lend those funds. The banks are rightfully concerned about competition from non-depository institutions, but allowing them to abandon local ties is not a solution. We firmly believe that financial institutions exist first to provide for the credit needs of the communities from which they draw deposits.

While proponents argue that concentration will improve efficiency and profitability, they offer no concrete evidence to support their assertion. In fact, small to medium-sized banks have historically been more profitable than very large ones and are regarded by their customers -- especially the small businessman -- as providing better service. The competitive advantages cited by those seeking to expand arise primarily from regulatory preferences, such as lower capital requirements, and not from greater efficiency.

In fact, concentration of banking introduces a serious element of inefficiency in that it deprives the loan officer of personal knowledge about the character of the prospective borrower and the value of his collateral or proposed project. The importance to sound underwriting of local knowledge is what compensates for the "inefficiency" of processing smaller loans and consistently produces superior results for "unsophisticated" small to mid-sized banks who know their local markets and keep pace with them. Without these local lenders small businessmen will pay more for credit, not because they are poor credit risks, but because their creditworthiness is unknown in New York and Chicago.

Certainly technology can somewhat alleviate this problem. Computerized mortgage underwriting is well advanced and can probably be refined sufficiently to serve the well-qualified homebuyer adequately. But what about the marginal borrower such as the young first-time homebuyer? Who will work with him? And finally, who will make the construction loan to build the house in the first place? Even the most ardent advocates of technology in banking cannot show how construction lending could be handled without personal knowledge and involvement by the lender. As a consequence, concentration of banking will force concentration in industries, such as homebuilding, that are heavily dependent on financing.

The ultimate result of deregulation may be that so long as a foreign government is offering to borrow a large sum of money at a higher rate than the local builder or other small businessman, the bank will send its money abroad irrespective of the quality of the credit. You can imagine the chagrin of builders around the country who watched as resources from their own communities were lent to foreign countries when they could not obtain construction loans at any interest rate. Many of those builders went out of business. And they have no access to an International Monetary Fund for assistance.

DIRECT INVESTMENT IN REAL ESTATE BY FINANCIAL INSTITUTIONS

More financial institutions are competing directly in real estate development with independent builders and developers. Some are joint venturing with established builders and developers. Others are employing companies to develop land that they own. Federal thrift associations have the authority to invest 3% of their assets in service corporations, which in turn have the power to invest directly in real estate development. Most state S&L's have similar power, either through service corporations or through their main operations. While federal banks do not have the authority, some states are considering whether to give state chartered banks the authority.

This trend creates several problems. First, direct competition between financial institutions and independent builders and developers is unequal and unfair. The financial institutions have the inherent ability to secure site financing at more favorable terms than are available to independent companies. The financial institutions can extend more favorable construction and mortgage financing to their projects. They can process their own home buying clients faster. They do not have to show the same profit as an independent in order to stay in business because they will not foreclose on their own projects and can subsidize their development operations when necessary from their parent operations.

A second problem is anti-competitive practices by financial institutions. Normally, this takes the form of preferential lending. The financial institution offers below market construction and mortgage financing on projects in which it has an interest. Some S&L's have even refused to extend loans except on projects in which they have an interest, effecively cutting their building competitors off from their traditional source of financing. A final abuse is the tying arrangement. A loan customer may be obliged to obtain another service such as a business checking account in order to obtain construction or permanent financing.

A third problem is the long term possibility of financial institutions setting up companies that control virtually all aspects of the real estate development business. This vertical integration would involve the same company buying land, developing it, building, marketing, financing acquisition by its customers, and insuring mortgages. In addition to their real estate development powers, federal thrifts' service corporations already can acquire and rent commercial real estate, renovate commercial real estate, provide property management services, and provide real estate brokerage service for their own projects. This trend will eliminate competition and concentrate control of development in fewer, larger companies controlled by banks and thrifts. Those large institutions would then be freer to raise prices and to destroy price competition.

The Administration is proposing that Congress let bank holding companies set up subsidiaries that can invest directly in real estate. Just as with thrift service corporations, we believe this is a short sighted change that trades off the long term interest of the free market system for possible short-term benefits to financial institutions and very few consumers. Using its financial leverage the bank holding company will be able to arrange preferential financing to the customers of its development subsidiary. We have no doubt that they can undercut the small builder or developer who must obtain construction financing at market rates and whose customers must get permanent financing at market rates. We view large banks as a greater threat to competition than thrifts because of their phenomenal assets and remoteness from local communities.

Banks and thrifts engaging in real estate development, will actually harm the competitive system. Their success will be at the cost of the small and medium-sized builder. These builders usually do not have alternatives for financing. They can not bypass the banks and thrifts as can the larger builders. Especially in small markets, the smaller builder is almost wholly dependent on traditional lenders. He cannot compete with them.

The subsidiary is not an answer to the questions of risk and fair dealing. Rules written requiring arms length transactions will not in fact preclude preferential treatment of a subsidiary by its parent corporation or affiliates. Also, the risk to the parent may be reduced but will not be eliminated by the use of a subsidiary. Its profits and losses are still reflected in the parent's operations.

We strongly believe that the division between commerce and finance should be maintained in the case of real estate development.

CONCLUSION

We are optimistic about the housing recovery. Economic signs are positive to date. Yet it is too soon to gauge the long term strength of the recovery because of uncertainities about interest rates and prospects of large federal deficits. As we look at the future of the housing industry in the context of the changes in the financial services industry, NAHB wants to ensure that credit will be available to the homebuyer and the small businessman at rates they can afford.

We are looking to a number of sources for mortgage credit in the future. Traditional lenders will continue to originate residential mortgages but will be more likely to resell them on the capital markets. The federal and state governments will continue to have an important role in providing assistance to those whom the conventional market cannot serve adequately.

The secondary mortgage market is the cornerstone of residential mortgage finance now and in the future. Increasingly with the use of mortgage-backed securities, the secondary mortgage market will link the range of investors to the homebuyer. Trusts for Investments in Mortgages offer a means of eliminating the major tax, legal and regulatory obstacles in the way of conventional MBS's. We endorse the concept of TIM's provided that it does not weaken the ability of FNMA and FHLMC to provide support to housing. We hope that Congress will give thoughtful consideration to any proposal submitted by the Administration. The larger homebuilders are beginning to issue their own taxable bonds, using their mortgages as security. These builder bonds offer a promising vehicle for the larger builders. To help boost their use, we recommend that Congress remove the current limitations on FNMA's ability to make loans on the security of mortgages.

We believe more funds can be attracted to home financing from pensions, retail and foreign investors. Pensions could invest more if conventional MBS's given an investment rating by a rating agency were exempt from the prohibited transactions rules. Representatives Gephardt and Wyden have introduced H.R. 1418, which we strongly support, which would make the changes needed to make uniform, reliable mortgages investments more possible by pensions. Retail offerings using mortgage pools and unit investment trusts can help small institutional individual investors invest in housing. Foreign investors are potentially a huge source of funds for real estate investment. Congress should review ways to make foreign investment more attractive and practical under our tax laws.

NAHB itself is innovating in order to attract capital to housing.

With the National Association of Realtors, we have just launched the Home Investors Fund, a no-load open-ended mutual fund that is investing in GNMA and other MBS's. We also started the Home Mortgage Access Corporation to aggregate builder demand for mortgage finance and to negotiate with secondary market entities for commitments at favorable rates and on favorable terms.

We are concerned about certain trends in the financial services industry. We are opposed to the centralization of the financial regulatory agencies. We believe that a central federal bureaucracy will diminish innovation and will not enhance the provision of credit for the full range of needs. We also view the rapid consolidation and concentration of the financial services industry into larger institutions as harmful to the delivery of credit to small business. Community based lending is needed to make lending responsive to the multiple needs found throughout the nation.

Lastly, we are adamantly opposed to the expansion of banks and thrifts into direct real estate investment. Their competition with small, independent builders and land developers will be inherently unequal and unfair. Their entry into the real estate business will prompt anti-competitive actions against their small competitors. Vertical integration of the industry is a likely outcome of their expansion and will reduce competition in the long run. We recommend that the wall between financing and real estate commerce be kept intact.

In considering the future of the financial services industry, it is important that we keep people and not just institutions foremost in our minds. Whether the homebuyer, the small businessman, or the American public in general, we are all the customers of and the justification for the financial services industry.

I appreciate the opportunity to present our views on this wide-ranging and vital area. I would be happy to answer any questions you may have.

Senator HECHT [presiding]. Thank you, Mr. Gilman. Our last panelist is Dr. Thomas R. Harter, senior staff vice president and chief economist, Mortgage Bankers Association.

STATEMENT OF DR. THOMAS R. HARTER, SENIOR STAFF VICE PRESIDENT AND CHIEF ECONOMIST, MORTGAGE BANKERS ASSOCIATION

Mr. HARTER. Thank you, Mr. Chairman. It's a privilege to appear here and discuss the potential problems and impacts of the reregulation of America's financial institutions.

One of the major concerns in any restructuring of our financial system that, has been continually brought out in the process, has been that of the availability of residential real estate credit.

While it is too early to evaluate the specifics of the introduction of the Garn-St Germain bill in 1982, we can observe some of the shifts in the home financing market over the recent past that have implications for changes that are impacting the various financial institutions.

SHIFT IN MORTGAGE LENDING ACTIVITY

Recently we've witnessed the partial withdrawal of the traditional mortgage lenders from the mortgage origination market. However, others have moved in to fill that void and the availability of mortgage credit has not become a problem.

This shift in mortgage lending activity has largely occurred through secondary markets with over half of all residential loans originated in 1982 being sold in the secondary mortgage market.

The Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Government National Mortgage Association mortgage-backed securities, have provided the means for maintaining a continued flow of funds for mortgage lending.

The regulation of these secondary markets is, however, restricting mortgage credit flow for particular segments of the housing market.

Arbitrary limits on the size of loans that these secondary market participants may deal with have restricted secondary market activity to only part of the market.

Because of the tremendously increased importance of the secondary market for mortgage loans, we suggest that loan limit restrictions imposed on those markets be eliminated, or at least raised substantially, to allow substitute lenders to be able to pick up the void created by the changing nature of traditional mortgage lenders.

Because the void in real estate credit is likely to grow with the broadening of asset powers, it is important to adjust the secondary markets quickly if we are to avoid dislocations caused by arbitrary restrictions on loan size.

CREDIT BUDGET LIMITS

Another restrictive feature facing the secondary markets is the credit budget limits imposed on FHA and Ginnie Mae volumes.

If these limits on overall activity become binding, the secondary markets will be unable to pick up the slack as traditional portfolio lenders divert funds into a wider range of investment alternatives.

This is the worst possible time to restrict the secondary market operations of this country's mortgage markets.

Three years ago, Congress took a major step in allowing residential mortgage credit to compete in national markets for funds during periods of high interest rates. The preemption of State usury limits for residential mortgages allowed the consumer to continue to obtain credit, if the borrower so desired. However, the override of usury limits isn't complete. Usury limits for agricultural, business and other consumer loans still exist. By restricting the availability of agricultural, business, and other consumer credit, the residential mortgage for first liens on residential real estate will be the only form of credit available, once usury limits are exceeded in other areas.

This lack of a free market in other areas will place tremendous pressures on the first lien on residential real estate in periods of high interest rates. In particular, the lack of a usury preemption for junior liens will force homeowners to refinance first liens, in order to borrow against their home equity. This process will force homeowners to refinance in the first lien markets and thereby increase mortgage credit demands in periods of already high interest rates. This increased demand will cause interest rates on first liens to remain at a higher level than they would otherwise, thus amplifying the swings in residential real estate activity.

We, therefore, suggest that usury limits of all types be preempted as was done in the residential first lien area.

CONFLICT IN THE AREA OF PREPAYMENT PRIVILEGES

Another area of conflict between State laws and secondary markets lies in the area of prepayment privileges. Traditional conventional loans are written with what has become known as a prepayment penalty. The right of the borrower to pay a long-term loan early is, in fact, an option given to the borrower by the lender, and the price of the option is the prepayment penalty. If the States are allowed to prohibit the explicit pricing of the prepayment option through a prepayment penalty, the result will take one or a combination of forms. Either the loan instrument will be issued with a shorter maturity, as was done when the prohibition of enforcement of the due on sale clause surfaced, or every borrower will be charged for the option, rather than those that simply use the option. Thus, there would be a higher cost for the loan initially.

In either case, the mortgage loan will become more costly and more people will be eliminated from the market. The current method of charging for the prepayment option only when it is exercised, limits the cost of the option to only those borrowers that exercise it.

Again, Federal preemption of the prohibition of enforcement of prepayment penalties would preserve the long-term mortgage and aid in maintaining the greatest participation in the home-buying population.

Last year the prohibited transactions section of ERISA was subject to congressional attention, as well as new interpretations by the Department of Labor. Substantial progress has been made toward freeing pension fund investment in mortgage loans. However, ERISA still needs further clarification and simplification. Current ERISA regulations and laws prohibit experts in the real estate field from advising on transactions in their area of expertise and dealing with pension fund investors as they would other investors. Reputable and experienced mortgage bankers, real estate firms and institutional investors should be allowed to serve as pension fund advisors concerning all real estate transactions and offer a full range of market investments.

The entire area of law and regulation of financial institutions and transactions needs to be brought rapidly into todays environment. Technology is already far ahead of the regulatory framework that cripples our financial institutions and transactions. While the United States is still examining statewide branching and possibly nationwide branching, communications satellites are in place to transfer funds around the world at the speed of light. Our institutions and financial transactions must be kept as flexible as possible to meet the challenges of tomorrow.

The statutory and regulatory framework that sets prices, restricts participants and excludes expert participation in their fields of expertise does not prepare our financial system for the challenges tomorrow and leaves us behind.

I thank you for this opportunity and would be happy to answer any question you may have.

[The complete statement follows:]

STATEMENT OF DR. THOMAS R. HARTER, SENIOR STAFF VICE PRESIDENT AND CHIEF ECONOMIST, MORTGAGE BANKERS ASSOCIATION OF AMERICA

Mr. Chairman and Members of the Committee, my name is Thomas R. Harter. I am Senior Vice President and Chief Economist of the Mortgage Bankers Association of America.* Accompanying me today are Burton C. Wood, MBA's Legislative Counsel and William E. Cumberland, MBA's General Counsel.

We appreciate the opportunity to appear before this Committee to participate in hearings designed to gather information on the current status of the financial services industry and to explore the future direction of that industry. In particular, I will focus my comments toward your request on how the financial services industry's structure will affect housing finance, but I will also address some implications concerning the financing of income-producing real estate as well.

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*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership is comprised of mortgage originators, mortgage investors, and a variety of industry related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios. Members include:

- o Mortgage Banking Companies
- o Mortgage Insurance companies
- o Life Insurance companies
- o Commercial Banks
- o Mutual Savings Banks
- o Savings and Loan Associations
- o Pension Funds
- o Mortgage Brokers
- o Title Companies
- o State Housing Agencies
- o Investment Bankers
- o Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; telephone: (202) 861-6500

Expansion of Financial Institutions' Authority

Passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, as well as the Garn-St Germain Depository Institutions Act of 1982, has raised the level of concern about the availability of adequate supplies of housing finance. The concern about the availability of real estate financing has its origins prior to 1970 with the Hunt Commission Report[1] and later with the FINE study[2]. Congress had been studying the potential impact of deregulation on financial institutions in the United States for the past decade and a half, resulting in the deregulation initiatives passed in 1980 and 1982. While it is still too early to evaluate the impact of these pieces of legislation completely, we do have evidence concerning residential real estate finance that is instructive in anticipating the impact of allowing traditionally captive mortgage lenders, such as savings and loan associations, authority to invest in alternative assets.

During the period from 1978 through the present, thrift institutions have faced increased competition for savings funds from non-traditional savings institutions. The most notable example of such competition came from investment banking institutions in the form of money market funds. Not only did the investment banking accounts divert the flow of new savings from thrift institutions and life insurance companies, but money market accounts also caused people to withdraw existing deposits from banks and thrifts, as well as to borrow on life insurance policies, in order to establish money market accounts.

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[1] Report of the Presidential Commission on Financial Structure and Regulation, December, 1971.

[2] Financial Institutions and the Nation's Economy (FINE), U.S. House of Representatives, Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions, 1976.

Federal regulation of banks and thrifts, most notably Regulation Q of the Federal Reserve System, prohibited these depository institutions from meeting the competition for funds initiated by the money market accounts offered by investment bankers. Similarly, life insurance companies experienced a tremendous outflow of funds in the form of policy loans, which state law required them to offer at far below market interest rates. Thus, the regulatory environment prohibited both depository institutions, as well as life insurance companies, from competing with the investment bankers for funds.

Success of Money Market Funds

The irony of the investment bankers' money market fund success lies in the investment of the money market funds. A large percentage of the assets of the investment banker money market funds was reinvested in the institutions from which the funds were attracted, in the form of certificates of deposit of $100,000, or more, that were exempt from Regulation Q limits. Depository institutions did not pool their smaller accounts into $100,000 packages, in order to pay competititve rates and retain the funds for themselves, because regulations prohibited banks and thrifts from pooling their existing deposits into large pools to circumvent Regulation Q limits. Therefore, the market was ripe for a third party to offer such a pooling, and the investment bankers served that role very effectively.

There are many lessons that we can learn from observation of the impact of the flow of funds during the 1978 to 1982 period that provide valuable information about the likely impact of changed regulations or elimination of regulation.

First, the success of the investment banker money market funds demonstrated that consumer loyalty to local institutions is very weak and is much more sensitive to price than to local ownership and control.

Second, insurance of deposits is of questionable value when the alternative investment is of government debt quality, or is re-deposited with the institutions from which it was withdrawn.

Third, geographic location is no longer the measure of convenience that it once was. Improved communications systems, in terms of mail, telephone, and electronic transfer systems, provide consumers with a convenience factor equal to, or greater than, geographic location.

Fourth, when funds were diverted from traditional real estate lending institutions, other lenders stepped in to provide mortgage loans for potential homeowners.

Fifth, as other lenders became more important in the real estate lending market, the secondary markets for mortgages grew tremendously in terms of the volume of mortgage activity handled.

Sixth, with secondary market volumes for mortgage loans rising substantially, markets developed for futures and options in mortgage securities that have allowed lenders to hedge their risks in the lending process.

Expanded Market

The activity of the past five years may have other implications, but none is clearer than that the flow of funds in the United States no longer occurs on a localized basis, but has moved into national markets. Even though, in fact, the flow of funds has become global, we are more concerned today with the move from local, state, and regional markets to national markets. Mortgage bankers have already been involved in discussions with foreign investors as to how they could hedge the exchange rate risk on long term investments, such as 30-year mortgage loans and real estate equity positions sold through international syndication.

Effect of Deregulation

Returning to the potential impact of regulatory change on real estate lending, the past five years demonstrate some very important aspects of deregulation. Limits on the rate that depository institutions can pay for funds had to be eliminated if those institutions were to survive. As the rates paid for deposits rose during the last five years of the 1970s, it became clear that, because someone would pay the market rate, those entities prohibited from doing so would disappear. The Depository Institutions Deregulation and Monetary Control Act of 1980 came in time to allow the traditional institutions to begin to compete on a rate basis in order to maintain their position in the market. The depository institutions were, in effect, unshackled from an outmoded usury law that prohibited them from obtaining funds in what had become a national market.

Similarly, the consumer was partly freed from outmoded and unnecessary usury laws concerning residential mortgage loans. However, agricultural and business loans are not spared from restrictive usury laws and these borrowers should be allowed to obtain funds in the national markets at market rates. The preemptions that Congress enacted in 1980 for business and agricultural loans expired in March of this year. MBA respectfully urges Congress to provide a permanent preemption for business and agricultural loans, and for junior residential mortgage liens as well. The consequence of not having free agricultural, business, and junior mortgage rates is dislocation in the Nation's credit markets from time to time, as interest rates rise above localized usury limits. The Federal preemption of state usury laws in 1980 was a major step forward in recognition of the national market in first lien real estate loans for residential properties, and would serve the same function for agricultural, business, and junior lien residential loans.

Deregulation also has affected the ability of thrifts to provide sufficient supplies of mortgage credit. Thrift institutions held large asset portfolios of old mortgage loans made at low interest rates, which were tied to their captive source of cheaper funds or were required to stay under low usury limits. When funds were no longer relatively cheap after the deregulation of rates and usury limits had been lifted, these institutions were no longer willing to continue to build their portfolios with the same type of fixed-rate, long-term asset. During the last five years, we have witnessed the growth of many different types of mortgage loans designed to allow the yield on the loans to vary more or less with market rate variations. This type of feature allows an investor to increase the return on assets as the cost of liabilities increases in the marketplace. The thrift industry has not been highly successful in promoting these adjustable rate mortgages, and consumers have consistently reconfirmed their preference for a fixed-rate loan. Therefore, many thrift institutions have increased their activity in secondary mortgage markets with fixed-rate loans.

As thrifts reduced their flow of funds to mortgage lending due to the loss of savings accounts to money market funds, the share of real estate originations provided by mortgage bankers began to increase. Even more importantly, the volume of conventional loans originated by mortgage bankers rose at a relatively rapid pace. Another significant effect of the recent high mortgage rates was that home sellers began to provide a larger share of the mortgage credit necessary to sell their houses. This activity has been difficult to measure statistically, but can be expected to abate as long as interest rates remain at affordable levels and to resurface whenever interest rates increase significantly.

Secondary Market

The increased lending volume finding its way to secondary markets is easily proven by looking at the volume of loans sold to secondary market investors relative to loans originated. During the 1970s, the volume of loans sold in secondary markets compared to loans originated ranged between 32 percent and 38 percent for one- to four-unit residential loans. By 1982, the volume of loans sold in secondary markets relative to the volume of originations exceeded 100 percent. In other words, there were more loans sold in 1982 than there were loans originated during 1982. This was a startling new phenomenon—not only were new loans being sold, but older loans were being removed from portfolios and sold in the secondary markets—mortgage portfolios were being liquified, mainly by thrift institutions.

If the older loans being "swapped" are statistically removed, statistics show that about 60 percent of the new loan originations of one- to four-unit residential mortgage loans are being sold in secondary markets. The conversion of mortgage loans into securities is accomplished under programs offered by the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Government National Mortgage Association (GNMA). Sales of these securities on "Wall Street" were providing the traditional mortgage lenders with an investment that was easier to work with, and that would be easier to sell when in need of liquidity. This evolution is continuing, as evidenced by the recent announcement by FHLMC of a new Collateralized Mortgage Obligation (CMO) security, which will provide various maturities to attract different types of investors, and by the proposed development of tax law changes to allow mortgage-backed securities based on managed mortgage pools.

FNMA and FHLMC Mortgage Purchase Limits

Even within the secondary markets, regulations are adversely affecting home financing. The artificial limits on the size of loans that may be purchased by FNMA and FHLMC restrict the market for larger homes. This tends to erode the "move up" market for housing and creates a shortage of affordable existing housing for first time homebuyers. This shift from the historical pattern where existing homeowners moved up to larger new homes has, in part, forced first time homebuyers into purchasing smaller, higher density housing, usually in the condominium form. We are, to a degree, forcing first time homebuyers to purchase their apartments because of the restrictions on the size of loans in the secondary markets, which limits the ability of existing homeowners to obtain financing in order to move up to a larger new home. The restricted ability of existing homeowners to obtain financing through secondary markets reduces upward mobility in homeownership and creates a shortage of existing homes available for first time purchasers. This, in turn, affects homebuilding by turning its resources toward the production of smaller high density projects, or conversions of rental property to ownership. This adds to the shortage of rental housing as existing rental units are converted to ownership units. Removing the limits on loan sizes that the secondary markets could purchase would make more financing available to all participants in the housing markets, but, more importantly, there would be more housing available for everyone.

The dislocation of credit caused by the limit on loan size in the secondary markets will become more restrictive on real estate transactions in the future as traditional providers of mortgage funds reduce the proportion of new funds for real estate lending. Broader asset powers for banks and thrift institutions will reduce the amount of funds going into mortgage loan investments that cannot be sold through the secondary markets. This segmentation of the housing market, via regulations in the secondary markets, will mean a smaller supply of funds for financing larger balance loans and, thereby, slow the sale of existing homes. Because first time homebuyers traditionally buy existing houses, the supply of housing available for first time homebuyers will shrink, and prices are likely to rise. Such a situation will compound the affordability problems of first time homebuyers, and cause existing homeowners to become less mobile in terms of housing.

Rate and Other Regulatory Restrictions

Other regulations and statutes affect the direct lending ability of originators of mortgages, as well as the marketability of those loans actually produced. For example, the combination of an administered interest rate on Federal Housing Administration (FHA) and Veterans Administration (VA) mortgage loans and the requirement by GNMA that all loans in a specific pool must carry the same interest rate, creates marketability problems during periods of changing interest rates. It takes time for a mortgage originator to assemble enough loans at a given FHA/VA rate in order to meet the GNMA requirements for a mortgage pool (this minimum requirement sets both the minimum number of loans, as well as minimum dollar volume). Because all loans in a GNMA pool must be FHA or VA loans, the originator has to be able to accumulate the minimum volumes before there is an interest rate change. If loan originators cannot accumulate the minimum volume requirements before the interest rate maximum changes, it would be impossible to produce the volume of loans necessary to meet GNMA pool requirements. Therefore, lenders stand a substantial risk of loss in the following areas: the commitment fees paid to sell the pool; any hedging position they have taken against the potential pool; the warehousing of the loans already made before the rate change; and the administrative costs of those loans already closed.

If the administered FHA/VA rate is changing rapidly, lenders will have to withdraw from the GNMA market for periods when rates are expected to change. The combination of regulations and laws causes temporary disruptions in the flow of mortgage credit, as well as increasing the cost of doing business and, thereby, the cost of mortgage credit. This problem may be alleviated to some extent with the advent of the GNMA II program, this summer, which features jumbo loan pools and a lower minimum dollar amount for loan packages to be placed in these pools. However, the complete and much needed solution would be, via regulatory and legislative changes, to remove the administered interest rate on FHA and VA loans, allowing such loans to be made at negotiated market yields; to increase the size limits on FHA and VA loans to allow larger loan balances; and to eliminate the requirement that all loans in a GNMA pool must carry the same interest rate. The administered FHA/VA rate also creates market dislocations when it is not adjusted rapidly to changing conditions. If the rate is not reflective of market rates, then originators of FHA/VA loans cannot compete in the origination market. The inability to compete for FHA/VA loans means that lenders cannot fill requirements for GNMA pools and must face losses accordingly.

Origination Competition

While mortgage lenders have learned to live with regulations and statutes, such as those described above, the requirements amplify the swings in availability of mortgage credit and add to consumers' cost of mortgage credit. Such regulations add little, if anything, in the way of safety, but are disruptive and costly.

As the secondary markets for mortgage loans continued to grow during the late 1970s and into the 1980s, one of the major problems experienced was the variation of state law surrounding the mortgage lending area. Probably the best example of the state law problems was demonstrated by the usury problems of the late 1970s. State legislatures had not realized that mortgage loans were products bought and sold in national markets. Many of the state laws were designed with the thought that mortgage loans were made and held by local lenders, and that the funds for mortgages came from local institutions. As legislators and consumers became aware of the vast amou..t of mortgage credit that came from across state boundaries, they realized the problems that state statutes were causing with the flow of mortgage credit.

State usury laws were causing those states with extremely low usury limits to be excluded from attracting funds in the national capital markets. Many states began to change their usury limits as a result of being unable to secure the necessary credit to maintain the housing markets. Not only did the more restrictive states become excluded from the flow of funds from out-of-state lenders, but in-state institutions were forced to direct their funds to out-of-state investments in order to achieve returns that allowed them to maintain old deposits, as well as compete for new funds. The worst situation was probably that faced by Arkansas, where it was necessary to amend the state constitution and the state could not do so in time to preserve their housing market. Because of the problems caused by the various state usury limits, the Federal government was asked to preempt these laws in order to preserve the housing and mortgage markets.

For a host of other reasons, the same situation developed around the due-on-sale clause in most mortgage loans. As states began to pass legislation that prohibited the enforcement of due-on-sale, the secondary markets reacted by changing the mortgage credit contract entirely as a way of handling the problems created by making the due-on-sale clause unenforceable.

The reaction of FNMA was to require lenders in states that prohibited the enforcement of due-on-sale to offer mortgages with a seven year call provision. An even more dramatic response came from FHLMC, which refused even to purchase loans in states, such as Georgia, where not only was the due-on-sale provision unenforceable, but where the lender did not even have the right to evaluate the transfer based on the creditworthiness of the assumptor.

Congress, in developing the Federal preemption of state laws restricting the exercise of due-on-sale clauses, established certain Federal limitations regarding the exercise of due-on-sale clauses with regard to residential property, which have been interpreted by some lenders as possibly applicable to commercial property mortgages. MBA urges that Congress clarify that the Federal restrictions on the exercise of due-on-sale clauses in residential mortgages do not apply to commercial property mortgages.

Localized Versus National Mortgage Markets

There are some state statutes that restrict the nationwide flow of credit funds. In certain instances, Congress has chosen to address these broad-based problems with a Federal preemption. However, not all of the problems have been solved. Three examples of such potential problems center around mortgage loan contracts that were not in wide use at the time the laws were drafted.

First, is the body of state law concerning negative amortization of a mortgage loan. As financial institutions developed loans designed to minimize monthly payments as a way to aid homebuyers in facing affordability problems, they ran into various state statutues that prohibited the compounding of interest. Because a negative amortization loan defers interest payments, as well as principal payments, the lenders were prohibited from charging interest on the payments that were deferred. Therefore, a negative amortization loan in those states with such a prohibition would have become an interest free loan. Lenders would not make such a loan and secondary market purchasers would not buy such a loan if it were made. This state restriction, therefore, eliminated the development of negative amortization loans (graduated payment loans) for those potential homebuyers who needed to minimize their cash outlays early in the life of the loan, but who could afford larger payments later in their lives. Most notably, such a restriction has its major impact on individuals who are first time homebuyers. In the Garn-St Germain Depository Institutions Act, state restrictions on such alternative mortgage transactions were federally preempted.

The second example of state restriction on the flow of mortgage credit has to do with the previously mentioned problem—usury. The Federal preemption of state usury laws on residential mortgage loans, enacted in 1980, only applied to first liens. Junior liens, most notably, second mortgage liens, were not affected by the preemption. The implications for the market for second mortgage liens are the same as they were for first mortgages. The problems associated with second mortgage liens, however, were not thought to have an appreciable impact on housing, because seconds could be used to obtain funds for purposes other than housing. This should not be a strong reason because refinancing with a new first mortgage lien can serve the same purpose, but is more expensive in terms of cash outlay over the life of the new first mortgage. Therefore, by not preempting the usury limits on junior liens, Congress allowed a situation to be created in the market for junior mortgages that is the same as that created for first mortgages in the late 1970s.

A third set of examples of laws and regulations that interfere with the operation of the secondary, nationwide market for mortgage finance are those that outlaw prepayment penalties. From the lender's point of view, prepayment is a borrower's option and the cost of that option is reflected as a prepayment penalty. In financial markets, the privilege of paying off a debt instrument before payment is scheduled is known as a "call." A prepayment penalty in mortgages means that only those who exercise their option pay for the option. If prepayment penalty provisions are not allowed, all borrowers pay for the option, whether they exercise it or not.

Certain investors in mortgage-backed securities and other long-term securities do not want their money repaid to them ahead of schedule. Pension funds, especially, do not wish to be faced with unexpected decisions regarding where to reinvest funds that are repaid before anticipated. These investors welcome, and pay a premium for, investments which have protection against the debtor calling back the instrument early. The prepayment provision in a mortgage, or in the mortgages underlying a mortgage-backed security, provides an element of call protection, and permits the borrower to pay less yield. Yet FHA and VA regulations do not allow lenders to limit a borrower's privilege to call back the mortgage early by the inclusion of a prepayment penalty in the mortgage, and some states, by statute, prohibit the call protection in conventional loans.

The market is attempting to adapt to the restrictions on call protection in mortgages by developing securities with call protection based on the expectation that all the mortgages in the underlying pool will not pay off early, even though some will, and that, therefore, some of the securities can be designated as the last to be called. The concept of the newly announced creative FHLMC instrument, the Collateralized Mortgage Obligation, rests on this expectation, for example. But a more straightforward and dependable approach would be to remove regulatory and statutory barriers that prohibit a borrower to bargain call protection, in the form of a prepayment penalty, for a lower interest rate.

The common thread that runs through the regulatory and statutory framework surrounding residential real estate lending, specifically, and all real estate, generally, is that it is obsolete. Many of the laws and regulations governing real estate finance are designed around the 30-year, fixed-rate, self-amortizing loan made by, and held by, local institutions that obtain their funds in local markets. The environment within which most real estate finance regulation and law was designed, was assumed to be a local closed system with a single product. The current and future environment of real estate finance is directly opposite that which was used to develop existing state and Federal regulation and law. Real estate finance is carried on in a national marketplace, and involves a diversified line of products designed for the needs of a dynamic heterogeneous population. There is little role for state regulation and law in the flow of credit between geographic areas, or between various institutions. The changes in the regulatory framework of our traditional financial institutions will, in many cases, run headlong into the brick walls of state statutes and regulations. The increasingly important roles of large secondary markets in all areas of credit, but particularly in real estate credit, call for a greater standardization and centralization of the laws and regulations surrounding real estate credit transactions.

Artificial Limits on Secondary Market Activities

Two of the programs that have led to some of the greatest innovation in real estate finance have been the FHA and GNMA. Why have these institutions been highly successful in the face of a radically changing marketplace? The answer is relatively simple. FHA and VA loans have been exempt from the impact of outmoded state laws and regulations. They have also benefited from a centralized standardization that has made them homogeneous enough to sell in secondary markets. The standardization and national coverage of FHA and VA regulations allow investors to know what they are getting if it is an FHA or VA loan. This is not true in the conventional loan market because of the wide variety of state law and regulation that must be known if an investor is to purchase conventional loans.

The impact of the GNMA Mortgage-Backed Security (MBS) on real estate finance has been tremendous since its creation in 1969. Development of the GNMA MBS served as a model for the secondary market. Similarly, the FHLMC Participation Certificate served as a model for the mortgage backed security in the conventional loan market since its birth in 1970. The tremendous success of these two federally related agencies leads one to question why the private sector has not been successful in developing a mortgage-backed security. While there have been private issues of mortgage backed securities, such as those of the Bank of America during the 1970's, they have almost all involved private placements and have not achieved an importance in the marketplace. The fundamental difference is that GNMA and FHLMC enforce a discipline on the marketplace that can only be achieved by an independent third party. These organizations provide such an independent party that can represent to the market that some set of basic criteria has been met and that they stand ready to guarantee the payment on their securities because of this. It is almost impossible for a private party that has an interest in the mortgage transaction to play the role of a GNMA, FHLMC, or more recently FNMA.

Recent Federal initiatives designed to limit the amount of activity that can be done in a year by the FHA and GNMA are potential threats to the continued development of the secondary market for mortgage credit. To the extent that credit budget limits become restrictive, the impact on the secondary market would be disastrous. Any interruptions of the continuous flow of GNMA securities would cause a collapse of the futures and options markets that allow originators to hedge production risks. Without an ability to hedge risks, many originators would leave the market, and those that remained would charge more for taking the increased risk. The arbitrary and artificial limiting of the FHA and GNMA programs is potentially damaging and serves little or no benefit.

Furthermore, MBA strongly urges Congress not to take any action that would be adverse to operation of the current secondary activities of FNMA, FHLMC, and GNMA. We strongly encourage the entrance into the secondary market of alternative private market entities, but not at the expense of these proven, dependable and efficient federally related agencies. While we are still waiting the final results on the complete effect of deregulation under the Garn-St Germain act, Congress should not undermine the ability of these agencies to provide a stable source of mortgage credit.

Regulatory Impediments to Mortgage Credit

The Federal government has itself recognized the potential problems of conflict of interest created in the secondary market for real estate financing, as well as for other types of financing. The entire set of regulations concerning disclosure that permeates the regulatory structure of the Securities Exchange Commission, the Real Estate Settlement Procedures Act, and the Employee Retirement Income Security Act (ERISA), demonstrates the concern about an independent third party being involved in a transaction. This is particularly true in those transactions involving real estate financing and investment. In this area, the regulations have become so complicated, and have been extended so far, that they may be costing far more than the value that they provide.

For example, under ERISA, the Department of Labor has been required to issue extraordinarily complex interpretations of the law concerning possible conflicts of interest that may exist when a person, or company, who has some relationship to the pension fund, or its advisor, also has an interest in the real estate that the pension fund might purchase, such as being a tenant in an office bulding, managing the building, or even servicing the mortgage on the building. Last year the "prohibited transactions" section of ERISA was the subject of Congressional attention and of new interpretations by the Department of Labor. Substantial progress has been made toward freeing pension fund investment in mortgages; however, ERISA still needs simplification and clarification so that reputable and experienced mortgage bankers, real estate firms, and institutional investors may advise pension funds concerning all real estate transactions and offer a full range of market investments. ERISA laws and regulations are an example of prohibitions that often prevent experts in the field from advising on transactions in their area of expertise and dealing with pension investors as they would with other investors.

The entire area of law and regulation of financial institutions and transactions needs to be brought rapidly into today's environment. In fact, it would be advantageous if we could re-regulate with an eye to the future. Technology is already far ahead of the regulatory framework that crippled our financial institutions and transactions. While the United States is still examining statewide branching, and possible nationwide branching, communications satellites are in place that transfer funds around the world at the speed of light. While we still discuss the banking system as the focus of the demand deposit system, we have given thrifts demand deposit authority, but only in select segments of the market. Yet, we are all aware that Sears is cashing checks written on a Dean Witter cash management account. Even in the area of real estate finance, we are running into the realities of the future.

Conclusion

The United States faces a statutory and regulatory framework for its financial institutions and real estate transactions that no longer fits the environment. Such a structure cannot be successfully dismantled piecemeal, but needs a major overhaul. In the international realm we already see mortgage bankers acting as investment advisors to foreign pension funds. We also can witness the success of countries, such as Japan, which are unencumbered by state laws and regulations, making substantially more progress in the development of secondary markets for real estate finance than countries, such as the United States and Australia, which are encumbered by a variety of state laws and regulations.

The Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain legislation of 1982 were substantial steps toward updating our financial system to face today's environment. There is still a long way to go and we hope that Congress will actively pursue the continued change of the financial structure of the United States so that our financial industry does not go the way of our industrial sector, when it, too, is faced with strong foreign competition. We must operate not only in the world of international trade, but of international finance as well. Our institutions and financial transactions must be kept as flexible as possible to meet the challenges of tomorrow. A statutory and regulatory framework that sets prices (even maximums), restricts participants, and excludes experts from participation in their areas of expertise does not prepare our financial systems for the challenges of today, and will leave us behind tomorrow.

We appreciate the opportunity to appear before you today and will be pleased to furnish any additional information if needed.

Senator HECHT. I thank all of you.

There are no further panelists. Unfortunately, due to the shortness of time, I will not be asking questions.

I thank everyone for coming. The hearing is adjourned. Thank you.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

FINANCIAL SERVICES INDUSTRY—OVERSIGHT
Part II

TUESDAY, JUNE 21, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met, at 9:30 a.m., in room SD–538, Dirksen Senate Office Building, Senator John Heinz presiding.

Present: Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. The Committee on Banking, Housing, and Urban Affairs will come to order.

I want to announce that Senator Garn is down at a leadership meeting at the White House and will be delayed from returning to chair this hearing probably until 10 o'clock.

Before we turn to our first witness, the Honorable Doug Barnard, I would like to observe that in the midst of our struggle to achieve a full economic recovery, no one would advocate a policy that discourages savings, taxes the investment itself and not the income from the investment, drives funds out of local depository institutions, and makes monetary policy more difficult to execute.

Yet such a policy is already in place and on the books. And the failure to pay depositors a return on the portion of their money that the Federal Reserve Board requires to be held without interest is indeed such a policy.

Last year we thought we achieved a great success for consumers, the economy, and healthy competition among financial institutions when Congress ordered the creation of deposit accounts for small savers that bear market rates of interest.

In some ways this was a success, the money market deposit accounts, which have severe restrictions on the ability of the customers to access their funds, but they attracted $300 billion back into depository institutions. But in other ways that measure was a flop, because less than $30 billion has returned to the checking account format, the super NOW accounts.

What is the difference between the two accounts? In a word it is the interest rate. The money market account pays a substantially higher rate than the super NOW account. The reason is that 12 percent of the super NOW account deposits must be set aside as sterile reserves at the Federal Reserve Bank. The Fed invests that money and earns a market return, which it keeps. In effect the depositor is being forced to loan 12 percent of his money to the Federal Government without interest, 12 percent of these funds are taken out of the investment stream through this hidden tax. The depository institution loses the earnings reserve account, so the institution is simply unable to pay the depositor a full market rate of interest on his deposit, as Congress intended.

The money market deposit account mandated by the Garn-St Germain Act of 1982 was intended to be "directly equivalent to and competitive with money market mutual funds." As a result of reserve requirements imposed on the accounts, however, financial institutions cannot offer accounts which are fully competitive with those offered by the money market funds.

Assuming the 10-percent market rate, the 12-percent reserve requirement on business and organizations who hold super NOW accounts will impose a 136-basis-point penalty on regulated depository institutions.

Even with full transaction capability, it would be impossible for an account, burdened by such an interest rate penalty, to compete effectively with money market funds or consumer deposits, let alone for business or professionally managed deposits. There are no reserves required on individual money market depository accounts, and as a result they have regularly paid depositors approximately 100 basis points more than the super NOW accounts.

The numbers tell the tale; 12 times as many dollars have flowed into MMDA accounts as into super NOW's.

Last year, I introduced a bill, S. 3059, which dealt with this problem in a straightforward way by requiring the Federal Reserve to pay depository institutions interest on the reserve account at a rate equal to the amount earned by the Federal Reserve on its investment portfolio. In other words, the Fed passes through to the institution the money they earn on the institution's reserve accounts. The institution could then pay depositors a higher rate or, alternatively, a lower lending rate, depending on whether it needed to attract more deposits or make more loans.

Financial institutions will be able to offer the fully competitive account only if they are permitted to earn a reasonable rate of return on reserves maintained in connection with the new money market deposit accounts.

S. 3059 would have instructed the Federal Reserve Board to invest its reserves in Government securities and to return on a pro rata basis the earnings from these investments to the financial institutions that actually own the reserves. The Board of Governors of the Federal Reserve has endorsed the payment of interest on all reserves, but advised that this should be done gradually in order to minimize any cost for the Treasury.

The legislation I intend to reintroduce today adopts this gradual approach, because it would only apply to reserves held against new accounts authorized under the Garn-St Germain Act of 1982, namely money market deposit accounts, the super NOW, and any transaction accounts, as well as to credit union accounts. All depository institutions, banks, S&L's, mutual savings banks, and credit unions will benefit from this bill, because it will make them more competitive and better able to attract deposits from their local communities which they can then relend in the local communities. Consumers at all institutions will benefit because they will earn a higher yield on their deposits and will be able to make an unlimited number of checking transactions.

My bill removes a major discouragement to savings and enables people to obtain the best rate in the most convenient way at their local depository institutions.

I am pleased to call our first witness today, Congressman Barnard, who is a distinguished Member of the House and he offered similar legislation in the House. He has, I might say, done yeoman's work in advancing similar legislation in the other body and, Congressman Barnard, we welcome you to the Senate Banking Committee. I and other members of the committee look forward to working with you to successfully make some progress on this legislation, get it enacted as soon as possible.

Will you please proceed?

STATEMENT OF DOUG BARNARD, JR., MEMBER, U.S. HOUSE OF REPRESENTATIVES, FROM THE STATE OF GEORGIA

Mr. **Barnard**. Thank you, Mr. Chairman. I am delighted to be here today and certainly on the occasion of your announcement that you are reintroducing the legislation that you introduced last year.

I would like to ask your permission that I might have my full testimony included in the record and I will summarize.

Senator **Heinz**. Without objection, it is so ordered.

Mr. **Barnard**. I also included with my testimony a letter from Chairman Paul Volcker to the Honorable Walter E. Fauntroy, chairman of the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs, in which Mr. Volcker has further enumerated his support for your legislation and the corresponding legislation that I have introduced in the House, H.R. 1013, which mandates the Fed pay interest——

Senator **Heinz**. May I ask what the date of the Volcker letter is?

Mr. **Barnard**. Yes, sir. The date is June 13, 1983.

Senator **Heinz**. Without objection it is so ordered.

The Chair would also place into the record, without objection, a letter just received from Paul Volcker, dated June 20, 1983, also endorsing the approach outlined in S. 3059 as we introduced it today.

[Letters received for the record follow:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

A. VOLCKER
AIRMAN

June 13, 1983

The Honorable Walter E. Fauntroy
Chairman
Subcommittee on Domestic Monetary Policy
Committee on Banking, Finance and
Urban Affairs
House of Representatives
Washington, D. C. 20515

Dear Walter:

I have now had an opportunity to discuss with the Board issues raised by the legislation introduced by Congressman Barnard requiring payment of interest on reserve balances held against deposit accounts that are directly competitive with money market funds. We feel that as a general matter payment of a market-related interest rate on reserve balances--whether held against deposit accounts specified in the proposed bill or against all deposit accounts requiring reserves--is worthwhile on grounds of equity and also on the more technical ground that it will work to discourage development of transactions-type accounts outside the depository system. Such accounts outside banks and thrift institutions would not under current law be subject to reserve requirements of the Federal Reserve, and their proliferation would complicate the implementation of monetary policy. However, the Board also generally believes that payment of interest on reserves should be phased in over time, taking due account of the potentially adverse effects on Treasury revenues under the current difficult fiscal conditions and to minimize complications for monetary policy associated with transition to the new way reserves would be treated by depository institutions if they were interest-bearing.

The bill in question would limit interest on reserve balances to money market deposit accounts (MMDAs), super-NOW accounts, and also, if our reading of the draft bill is correct, regular NOW accounts. The payment of interest on reserve balances held against MMDAs--only the non-personal portion of which is subject to reserve requirements--would be a step favored by the Board at this time.

Paying interest on reserve balances held against super-NOW accounts would make them more competitive with money market funds, although this might add further to uncertainties in interpreting the monetary aggregates, particularly M1, by causing a shift of funds now held in the form of MMDAs into super-NOW accounts. With interest paid on reserve balances, depositors would be able to receive as good a yield on super-NOW accounts as on MMDAs--abstracting from service charges depository institutions might impose--and the former would also have the capacity for unlimited transfers by check. But payment of interest on super-NOW reserve balances does open up the issue of whether interest should also be paid on reserve balances of all transactions accounts. As deregulation proceeds, it will be difficult to distinguish super-NOW accounts functionally from regular NOW accounts. Paying interest on all NOW account reserve balances--and perhaps at some point extended to balances held against demand deposits generally--would involve a fairly significant drain on Treasury revenues. Thus, while the Board as a matter of principle favors payment of interest on all reserve balances, the question of whether interest should be paid on reserve balances held against regular NOW accounts, or transactions accounts more generally, should be judged additionally from the perspective of overall fiscal considerations and equity in the raising of revenue.

As a final point, the Board feels that for technical monetary control reasons it would be better to pay interest on reserve balances on a more current basis than the one quarter lag in the proposed legislation. There would probably be less potential for complicating monetary control if the law gave the Board discretion to set a rate based on or related to market rates, or--if it were felt that more specificity was desirable--based on the average yield on, say, the System's Treasury bill portfolio in a current month.

Sincerely,

Paul

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

June 20, 1983

The Honorable John Heinz
United States Senate
Washington, D.C. 20510

Dear Senator Heinz:

I have now had an opportunity to discuss with the Board issues raised by the legislation introduced by you last year, S. 3059, requiring payment of interest on reserve balances held against deposit accounts that are directly competitive with money market funds. We feel that as a general matter payment of a market-related interest rate on reserve balances--whether held against deposit accounts specified in the proposed bill or against all deposit accounts requiring reserves--is worthwhile on grounds of equity and also on the more technical ground that it will work to discourage development of transactions-type accounts outside the depository system. Such accounts outside banks and thrift institutions would not under current law be subject to reserve requirements of the Federal Reserve, and their proliferation would complicate the implementation of monetary policy. However, the Board also generally believes that payment of interest on reserves should be phased in over time, taking due account of the potentially adverse effects on Treasury revenues under the current difficult fiscal conditions and to minimize complications for monetary policy associated with transition to the new way reserves would be treated by depository institutions if they were interest-bearing.

The bill in question would limit interest on reserve balances to money market deposit accounts (MMDAs), super-NOW accounts, and also, if our reading of the your bill is correct, regular NOW accounts. The payment of interest on reserve balances held against MMDAs--only the non-personal portion of which is subject to reserve requirements--would be a step favored by the Board at this time.

Paying interest on reserve balances held against super-NOW accounts would make them more competitive with money market funds, although this might add further to uncertainties in interpreting the monetary aggregates, particularly M1, by causing a shift of funds now held in the form of MMDAs into super-NOW accounts. With interest paid on reserve balances, depositors would be able to receive as good a yield on super-NOW accounts as on MMDAs--abstracting from service charges depository institutions might impose--and the former would also have the capacity for unlimited transfers by check. But payment of interest on super-NOW reserve balances does open up the issue of whether interest should also be paid on reserve balances of all transactions accounts. As deregulation proceeds, it will be difficult to distinguish super-NOW accounts functionally from regular NOW accounts. Paying interest on all NOW account reserve balances--and perhaps at some point extended to balances held against demand deposits generally--would involve a fairly significant drain on Treasury revenues. Thus, while the Board as a matter of principle favors payment of interest on all reserve balances, the question of whether interest should be paid on reserve balances held against regular NOW accounts, or transactions accounts more generally, should be judged additionally from the perspective of overall fiscal considerations and equity in the raising of revenue.

As a final point, the Board feels that for technical monetary control reasons it would be better to pay interest on reserve balances on a more current basis than the one quarter lag in your legislation. There would probably be less potential for complicating monetary control if the law gave the Board discretion to set a rate based on or related to market rates, or--if it were felt that more specificity was desirable--based on the average yield on, say, the System's Treasury bill portfolio in a current month.

Sincerely,

Paul

Mr. BARNARD. Mr. Chairman, I want also to say I commend highly the Senate on their very forward-thinking policy of looking into all aspects of the banking legislation. You did that last year and the results were very good legislation in the Garn-St Germain bill; one of the features of it that I respected so highly was the level-playing-field aspect, where we were trying to permit all elements, all financial institutions, nonregulated as well as regulated, to compete equally in the marketplace.

We thought we were making big strides toward this, but one flaw, as we both know, was the fact that the Fed did require reserves on money market funds, commercial accounts, and the super NOW accounts.

As you have so eloquently indicated this morning, this has distorted the marketplace and it should be corrected. I think that this legislation will go a long way, No. 1, to introducing the idea of interest on reserves, and hopefully as we test it, to see what the experience will be; then we may go back and look at the full reserves matter to see if this is not an unfair tax.

We have deliberated for many years on whether or not reserves are important to the control of monetary policy. It is still a big question. But if it is, it shouldn't be a hidden tax on institutions competing on an equal basis in the marketplace.

So I certainly commend your legislation, and I hope that the committee will move forward in incorporating it into the banking legislation which you anticipate.

Mr. Chairman, we are getting excellent support from the market as far as this legislation. I would like to submit into the record a letter of June 20, 1983, from the American Bankers Association endorsing the legislation.

Senator HEINZ. Without objection.

Mr. BARNARD. And a letter dated June 20, 1983, to me from the Consumer Bankers Association endorsing the legislation.

Senator HEINZ. Also so ordered.

Mr. BARNARD. And a letter to me dated June 20, 1983, from the National Association of Federal Credit Unions endorsing the legislation.

Senator HEINZ. So ordered.

Mr. BARNARD. And a letter dated—it seems all are dated the same date, but I am sure that is a coincidence—dated June 20, 1983, from the National Savings & Loan League.

Senator HEINZ. Without objection.

Mr. BARNARD. And a letter dated June 20, 1983, from the U.S. League of Savings Institutions.

Senator HEINZ. So ordered.

Mr. BARNARD. And then we have a little different one, dated June 21, 1983, from the National Association of Mutual Savings Banks. If I might include those in the record——

Senator HEINZ. Without objection, all of those will be placed in the record.

[The letters follow:]

AMERICAN
BANKERS
ASSOCIATION

1120 Connecticut Avenue N.W.
Washington D.C.
20036

EXECUTIVE DIRECTOR
GOVERNMENT RELATIONS

Gerald M. Lowrie
202/467-4097

June 20, 1983

The Honorable Doug Barnard
U. S. House of Representatives
Washington, D. C. 20515

Dear Doug:

On January 27, 1983, you introduced legislation that would provide for the payment of interest on reserves on those accounts established under Section 327 of the Garn-St Germain Depository Institutions Act of 1982.

In testimony before the Senate Banking Committee, on May 3, 1983, the American Bankers Association supported the concept of the payment of interest on reserves.

Depository institutions are currently required to hold reserve balances equal to a certain percentage of their transaction and non-personal time deposits. No interest is earned on these balances held at the Federal Reserve. This reduces the interest income of depository institutions and lowers the rate they can afford to pay on deposits.

Since most of the profits of the Federal Reserve are paid to the Treasury, failure to pay interest on reserve balances held at the Federal Reserve has the same effect as a tax on depository institutions, and indirectly, the customers who purchase financial services from them. Moreover, because the cost in reduced income from reserves must be made up through increased income on other bank products and services, a sterile reserve system indirectly maintains artificially high levels of interest rates on loans.

The prior rationale of not paying interest on reserves was due to the fact that these instituions received free services from the Federal Reserve. This, of course, is no longer the case since the Federal Reserve has begun explicity pricing its services. We are hopeful that similar legislation will be introduced in the Senate.

We stand ready to assist you in any way possible.

Sincerely,

Jerry

Gerald M. Lowrie

CBA THE
CONSUMER
BANKERS
ASSOCIATION

. . .an association for the
retail banking professional

June 20, 1983

The Honorable Doug Barnard, Jr.
United States House of Representatives
236 Cannon House Office Building
Washington, D.C. 20515

Dear Congressman Barnard:

The Consumer Bankers Association (CBA) represents the retail banking divisions of more than 500 commercial banks that hold over eighty percent (80%) of consumer deposits held by such institutions. In recognition of the changing face of our industry, CBA, in May 1983, opened its membership to any federally insured depository institution. Since that date, ten thrift associations have joined.

CBA members enthusiastically support H.R. 1013, the legislation you introduced that would require the Federal Reserve Board to pass to depository institutions the earnings on those reserves held on accounts authorized by the Garn - St Germain Depository Institutions Act of 1982. It is an excellent solution to the problems caused by sterile reserves. A market rate should be earned on all reserves held in transaction accounts, however, in view of the potential impact on the Treasury, H.R. 1013 correctly directs that it only apply to accounts authorized by the Garn - St. Germain Act. We believe that your approach will be the first step in phasing in the payment of earnings on reserves for all transaction accounts.

The Garn - St Germain Act directed the DIDC to design an account that would be "directly equivalent to and competitive with" money market mutual funds. As you know, sterile reserves impose a high cost to depository institutions, making these accounts less competitive than similar accounts offered by the non-regulated entities. Permitting the participating institutions to earn a yield on their required reserves appears to be the most equitable, efficient and economical way to insure that the new account fulfill the mandate of Congress. Further, it is not only critical but logical that depository institutions be permitted to earn a yield on money that, in fact, they own, but that is unavailable for investment.

Not only would this arrangement enable depository institutions to compete effectively for funds in the marketplace, but it would also enable the Federal Reserve Board to improve its ability to monitor the money supply since a greater proportion of these funds would come under its control.

We believe that H.R. 1013 is another major step towards the achievement of a competitive balance between depository institutions and money market mutual funds that Congress seeks. Depositors will benefit because they will be able to realize higher yields. Moreover, financial institutions will benefit as their cost of funds will be decreased. Further, U.S. Treasury revenues would benefit from the recapture of funds through taxes on institutions and depositors' earnings. Lastly, as we mentioned, the Federal Reserve Board would improve its control of the money supply, since regulated institutions would be able to attract and hold funds.

If you have any questions, please do not hesitate to call me.

Sincerely,

Drew V. Tidwell
General Counsel

National Association of
Federal Credit Unions
P.O. Box 3769
Washington, DC 20007
703/522-4770

June 20, 1983

The Honorable Doug Barnard
236 Cannon House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Congressman Barnard:

On behalf of the National Association of Federal Credit Unions (NAFCU), I would like to take this opportunity to thank you for introducing H.R. 1013, a bill which if enacted would require the Federal Reserve Bank to pay interest on reserves posted against Money Market Deposit Accounts and Super Now Accounts.

It has been the policy of this association to favor the payment of interest on all reserves posted with the Fed. We appreciate the steps taken in the Garn-St Germain Act to make less burdensome the reporting and reserving requirements for the smaller credit unions, but we still believe that a more equitable system would be to pay interest on reserves posted with the Fed. Sterile reserves constitute a hidden tax imposed upon the financial institution affected, and this cost of doing business must ultimately be passed on to the consumer.

It is reasonable to assume, given the competitive conditions of financial markets, that interest payments by the Fed on reserves would be reflected in the marketplace in the form of lower loan rates for borrowers and higher earning rates for savers. Accordingly, there would be a smaller amount of deductions from taxable personal income representing interest payments on loans, and greater interest income earned by savers. This may well off-set any additional costs to the Treasury.

Congressman Barnard, we feel H.R. 1013 is a step in the right direction towards NAFCU's adopted policy of earning interest on all posted reserves. We support your efforts and will be glad to work with you and your colleagues for enactment of this legislation.

Sincerely,

John J. Hutchinson
President

National Savings and Loan League

1101 15th Street NW
Washington, DC 20005
202 331-0270 Cable: NATLISA

Jim Cousins
Senior Vice President
For Governmental Affairs

June 20, 1983

Honorable Doug Barnard
236 Cannon House Office Building
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Barnard:

On behalf of the officers and members of the National Savings and Loan League, I want to thank you for introducing legislation providing for the payment of interest on reserves held by the Federal Reserve System against MMDA and Super-NOW account balances. These accounts were authorized by the DIDC (on instruction from Congress) in order to provide a competitive balance between traditional depository institutions and money market funds. The objective is one the National League supported given the "fact" that statutory limitations on money market funds was politically impossible.

In order for our institutions to be fully competitive with the funds, as Congress intended, they must be relieved of the tax on their raw material represented by the holding of sterile reserves. These reserve balances represent a substantial source of income for the Fed and for the Treasury. How, therefore, can anyone question that they represent a tax on the institutions?

The National League believes that interest should be paid by the Fed on all reserves, but your legislation addresses the most critical area and is the appropriate place to start. We are pleased to support your efforts and offer to assist you in any way we can in gaining enactment of the legislation.

Sincerely yours,

Jim Cousins

Jim Cousins

USL
UNITED STATES LEAGUE of SAVINGS INSTITUTIONS WASHINGTON OFFICE
1709 NEW YORK AVENUE, N.W. / WASHINGTON, D.C. 20006 / TEL. (202) 637-8900

ROY G. GREEN
Executive Vice President

June 20, 1983

The Honorable
Doug Barnard
House of Representatives
Washington, D.C. 20515

Dear Mr. Barnard:

The staff of the U.S. League of Savings Institutions has had an opportunity to study the bill you have introduced, HR1013, to require payment of interest by a Federal Reserve bank to financial institutions depositories on the reserves they are required to maintain on their money market deposit (MMDA) and Super-NOW accounts (authorized by regulation pursuant to Section 327 of the St Germain-Garn Depository Institutions Act of 1982). We construe that your bill would be applicable to reserves on NOW accounts as well. Presumably, the legislation would also require the payment of interest on any other account hereafter authorized under the St Germain-Garn law which is directly equivalent to and competitive with money market mutual funds.

The League wholeheartedly supports your effort and the basic thrust of the proposed legislation. If payment of interest on reserves could be expanded to all other accounts on which reserves are required, so much the better.

In principle, the payment of interest on reserve balances is only fair and equitable - particularly in view of competitive accounts, instruments, or investments offered by companies outside the depository institutions' segment of the market -- on which no reserve balances are presently required (or even provided for by statute). The yields which financial institutions can offer their customers on MMDA's and Super-NOWs obviously remain lower than they might otherwise be, since the reserve balances maintained in connection with these accounts remain sterile.

In the course of the legislative process, we would like to retain the opportunity to offer more specific suggestions concerning definitions, coverage, etc.

For now, we support the general thrust of your proposed legislation, and applaud both your initiative and concern for the public interest that financial institution accounts directly competitive with money market mutual funds be made even more competitive.

Sincerely,

Roy G. Green

Roy G. Green

RGG:lfm

THE AMERICAN HOME: THE SAFEGUARD OF AMERICAN LIBERTIES

NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS
WASHINGTON OFFICE
SUITE 200, 1709 NEW YORK AVENUE, N.W.
WASHINGTON, D.C. 20006
TELEPHONE (202) 783-8144

Since NAMSB 1920

June 21, 1983

The Honorable Doug Barnard
House of Representatives
Washington, D.C. 20515

Dear Mr. Barnard:

This letter is prompted by legislation which you have introduced, H.R. 1013, to authorize the Federal Reserve to pay interest on reserves held against money market deposit accounts (MMDAs). The National Association of Mutual Savings Banks is very pleased to endorse this legislation on both philosophical and practical grounds.

Consistent with the deregulatory philosophy which has been reshaping the nation's financial markets over the last several years, both depository institutions and their customers are adjusting to explicit pricing for the use of funds. A major anachronism in this trend toward increased market reliance is the federal law requiring depository institutions to set aside reserves in non-earning assets.

With respect to MMDAs, which constitute a large and still growing segment of our liability structure, there also arise competitive considerations since money market mutual funds are not subject to federal reserve requirements. Savings banks and other depository institutions are required to reserve against nonpersonal MMDAs at 3%, and at 12% on so-called Super NOW accounts when such accounts exceed $26 million per institution. Thus, for the very practical reason of being able to improve the marketability of these accounts through the return which depositors may earn, it would be advantageous to eliminate the current requirement for sterile reserves.

Paying interest on reserve requirements is a concept that has already been fully explored in prior congressional hearings, and which enjoys significant support (see, Hearings on the Monetary Policy Improvements Act of 1979, 96th Cong., 1st Sess., Feb. 1979). We note that the Federal Reserve Board itself has, in recent correspondence to Del. Walter E. Fauntroy, the chairman of the House Domestic Monetary Policy Subcommittee, expressed its endorsement of the proposal to pay interest on reserve balances. Such a step would also conform with the original congressional intent which led to the creation of these accounts by the Garn-St Germain Depository Institutions Act of 1982.

In addition to our general endorsement of the legislation, we would like to comment on one technical aspect to the legislation. Specifically, we would like to recommend a change that would alter subsection (a) of the legislation to delete the word "mutual" before "savings bank" in order to ensure that savings banks doing business in stock form would not be excluded from the benefits of the legislation. Over the course of the last eighteen months, a number of savings banks have converted from mutual to stock form, and there have also been a large number of conversions from savings and loan associations to federal savings banks, some of which involve stock institutions. We believe that the foregoing suggestion is purely technical in nature and would not alter the substance of the legislation.

Again, we would like to emphasize our support for H.R. 1013, and assure you of our commitment to work for its prompt and favorable consideration by the Congress.

Sincerely yours,

James J Butera

James J. Butera
Senior Vice President and Director

Mr. BARNARD. I might say for those who are going to come and say this is a great drain on the U.S. Treasury, I don't think that will prove to be true. If we started today, we would be talking about something like $240 million a year, which, after taxes on that, and it would be taxable, it is not that much of a loss to the U.S. Treasury. We consider the profit that the Federal Reserve has, the Treasury has, to be a minuscule loss to the banks.

Mr. Chairman, I welcome this opportunity and thank you very much for the opportunity to appear on behalf of your legislation and my legislation.

If there are any questions, I would be more than pleased to endeavor to answer them.

Senator HEINZ. Thank you very much, and let me commend you, Congressman, on having been the real pioneer in pushing for this legislation, a real organizer, as evidenced by the absolutely spontaneous outpouring of support that you organized on such short notice.

Mr. BARNARD. With the cooperation of the Post Office, I might say.

Senator HEINZ. Frankly, unsurpassed and unequaled cooperation from the Post Office.

I think there is a growing amount off support for this approach here in this committee. It is my hope that Chairman Garn will join in introducing this legislation today. I tried, frankly, to reach him yesterday, and he was not in town, and he had to go to the White House early this morning. But it is my hope that he and other members of the committee will join in this legislation as we introduce it today.

Frankly, I am indebted to you. We have been so tied up on the broad picture on this legislation that frankly it was your coming over here today that reminded me it was about time for me to reintroduce my bill from last year.

So I appreciate your stimulating my and the committee's interest in this important subject.

Mr. **Barnard**. Thank you very much. We will watch its progress with interest.

[The complete statement of Congressman Barnard follows:]

TESTIMONY OF

REP. DOUG BARNARD, JR.

BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

JUNE 21, 1983

Thank you, Mr. Chairman, for giving me the opportunity to appear before your committee today. I would like to explain my proposal to allow all depository institutions to pay consumers a market rate of interest on all new accounts authorized under last year's Garn-St Germain Act.

I know that I will receive a sympathetic hearing from you, inasmuch as you and Senator Tower were proponents of a similar plan during the debates that led up to the Monetary Control Act of 1980. And my good friend, Senator Heinz, sponsored this current proposal in the Senate last year.

Consumers were denied a market rate of interest on their deposits in the period between 1966 and 1982, when Regulation Q imposed a cap on the rates that could be paid on time deposits at all depository institutions. Under your leadership, that barrier was breached but not destroyed last year when Congress ordered the Depository Institutions Deregulatory Committee to create new, fully competitive accounts. The DIDC is moving as quickly as possible to phase out Reg Q rate ceilings, and they will all be gone no later than 1984.

However, one barrier to the payment of a full market rate remains outside the jurisdiction of the DIDC, and that is sterile reserves. My bill would require the Fed to pay depository institutions a fair market rate on the reserves they must hold for monetary policy purposes. That money would pass through to consumers, finally permitting banks to pay a full, fair market rate of interest to their depositors.

Congress mandated last year that all depository institutions be allowed to offer all customers an account "directly equivalent to and competitive with money market mutual funds." However, sterile reserve requirements make it impossible for an institution to offer an account that both permits unlimited check writing and pays a full market rate of interest. Money market mutual funds have no restrictions on checking and are not required to hold reserves, so they can pay a full market rate of interest.

Consumer enthusiasm has made the new limited checking Money Market Deposit Accounts an enormous success, attracting $360 billion in deposits between their introduction on December 14 and May 25. But the companion new Super NOW accounts are a comparative flop, having attracted only $30 billion during the same time.

The difference is caused by a hidden tax on Super NOW accounts which reduces their yield substantially. The tax takes the form of a 12 per cent reserve requirement, held at the Federal Reserve Bank in a sterile, non-earning account. As you know, all transaction accounts, both personal and business, must carry 12 per cent reserves. Current rates are approximately 8 per cent for MMDA's and only 7 per cent for Super NOW's.

No reserves at all are required for personal MMDA accounts, while non-personal MMDA's carry a three per cent reserve requirement. Approximately 85 per cent of MMDA deposits are in personal accounts.

The Federal Reserve invests the reserve deposits in U.S. Government securities, and earns a market rate. It retains the earnings and passes them on to the Treasury at year's end.

I have introduced H.R. 1013, which would require the Fed to pass the earnings on reserves held against these new accounts through to the institutions which took these deposits. This will eliminate the tax on deposits and permit the institutions either to pay a full market rate to their depositors or to reduce loan rates to borrowers.

This will be of particular benefit today to individual depositors in Super NOW accounts. Businesses cannot have Super NOW accounts at this time, although the DIDC is considering a proposal allowing businesses to have an interest bearing transaction account. If that is approved, small businesses will have the opportunity to earn a market rate on their checking accounts. Large businesses use sophisticated cash management techniques to earn a return on their idle funds.

Depository institutions will benefit because they will be more competitive and able to attract and hold more deposits. An important efficiency will be the elimination through consolidation of many accounts, since multiple accounts will be unnecessary. The need for many cash management transactions such as repurchase agreements and sweep accounts will be eliminated, making banking simpler and more efficient.

Customers will benefit from higher rates and simpler accounts. They will be encouraged to save. They will no longer seek to avoid the tax imposed by reserves, and will bring funds presently in non-reserved alternative investments back into the banking system, thus making the system more stable and predictable. Those funds will stay in local depository institutions, helping to fill local borrowing needs.

Finally, without this correction, the new accounts will never be able to serve those individuals and businesses that demand an account with both full transaction capability and a full market rate of interest. The two goals are mutually exclusive under present law.

Federal Reserve Chairman Paul Volcker, in a letter sent last week to my colleague, Rep. Walter Fauntroy, endorsed payment of interest on all reserves. Let me quote from his letter:

> "We feel that as a general matter, payment of a market related interest rate on reserve balances - whether held against deposit accounts specified in the proposed bill [H.R. 1013] or against all deposit accounts requiring reserves - is worthwhile on the grounds of equity and also on the more technical ground that it will work to discourage developments of transaction-type accounts outside the depository system."

The proposal is also endorsed by many depository institutions trade associations, and I would like to submit for the record at this point a number of letters from them, as well as the letter from the Federal Reserve.

The principal concern with this proposal is possible cost to the Treasury. I am certainly sensitive to the budget deficit, and this bill is designed to minimize the cost to the Treasury. It permits a gradual shift from sterile reserves to earning reserves. Permit me to elaborate.

Most of the deposits in MMDA's do not carry any reserves now. About 15 per cent of the $360 billion in MMDA's is in non-personal time deposits, and carry a 3 per cent reserve requirement. That would result in a maximum reserve requirement of $1.6 billion. All depository institutions together hold about $30 billion in Super NOW accounts, with a 12 per cent reserve requirement, which would produce reserves of $3.6 billion. So in the aggregate we are talking about a maximum of $5.2 billion in reserves against accounts authorized by Garn-St Germain.

Actually, the total that would be held in sterile accounts at Federal Reserve Banks is less, because many smaller institutions can satisfy their reserve requirements with vault cash, and the reserve requirements on the first $26.3 million in transaction accounts is only 3 per cent under the terms of the Monetary Control Act. I have attached an appendix which details reserve requirements.

As a practical matter, about 40 per cent of reserve requirements are satisfied by vault cash, so only $3 billion of that $5.2 billion would be held in sterile reserves. If all $3 billion were converted into earning reserves, and the portfolio yielded 8 per cent, the cost to the Fed would be $240 million. Of course, that is taxable income, so the Treasury would recover a substantial portion of that cost, probably at least one-third.

That is a modest price to pay for the benefits to be realized: payment of a market rate of interest to our depositors; achievement of competitive equity; encouragement of savings and investment; better control of monetary policy; further deregulation of the financial system; and a simpler, more efficient, fairer, better banking system.

Thank you for allowing me to appear, Mr. Chairman.

# # #

1.15 RESERVE REQUIREMENTS OF DEPOSITORY INSTITUTIONS[1]

Percent of deposits

Type of deposit, and deposit interval in millions of dollars	Member bank requirements before implementation of the Monetary Control Act		Type of deposit, and deposit interval[5]	Depository institution requirements after implementation of the Monetary Control Act[6]	
	Percent	Effective date		Percent	Effective date
Net demand[2]			*Net transaction accounts*[7,8]		
0–2	7	12/30/76	$0–$26.3 million	3	12/30/82
2–10	9½	12/30/76	Over $26.3 million	12	12/30/82
10–100	11¾	12/30/76			
100–400	12¾	12/30/76	*Nonpersonal time deposits*[9]		
Over 400	16¼	12/30/76	By original maturity		
Time and savings[2,3]			Less than 2½ years	3	3/31/83
Savings	3	3/16/67	2½ years or more	0	3/31/83
Time[4]			*Eurocurrency liabilities*		
0–5, by maturity			All types	3	11/13/80
30–179 days	3	3/16/67			
180 days to 4 years	2½	1/8/76			
4 years or more	1	10/30/75			
Over 5, by maturity					
30–179 days	6	12/12/74			
180 days to 4 years	2½	1/8/76			
4 years or more	1	10/30/75			

1. For changes in reserve requirements beginning 1963, see Board's *Annual Statistical Digest, 1971–1975* and for prior changes, see Board's *Annual Report* for 1976, table 13. Under provisions of the Monetary Control Act, depository institutions include commercial banks, mutual savings banks, savings and loan associations, credit unions, agencies and branches of foreign banks, and Edge Act corporations.

2. Requirement schedules are graduated, and each deposit interval applies to that part of the deposits of each bank. Demand deposits subject to reserve requirements were gross demand deposits minus cash items in process of collection and demand balances due from domestic banks.

The Federal Reserve Act as amended through 1978 specified different ranges of requirements for reserve city banks and for other banks. Reserve cities were designated under a criterion adopted effective Nov. 9, 1972, by which a bank having net demand deposits of more than $400 million was considered to have the character of business of a reserve city bank. The presence of the head office of such a bank constituted designation of that place as a reserve city. Cities in which there were Federal Reserve Banks or branches were also reserve cities. Any banks having net demand deposits of $400 million or less were considered to have the character of business of banks outside of reserve cities and were permitted to maintain reserves at ratios set for banks not in reserve cities.

Effective Aug. 24, 1978, the Regulation M reserve requirements on net balances due from domestic banks to their foreign branches and on deposits that foreign branches lend to U.S. residents were reduced to zero from 4 percent and 1 percent respectively. The Regulation D reserve requirement of borrowings from unrelated banks abroad was also reduced to zero from 4 percent.

Effective with the reserve computation period beginning Nov. 16, 1978, domestic deposits of Edge corporations were subject to the same reserve requirements as deposits of member banks.

3. Negotiable order of withdrawal (NOW) accounts and time deposits such as Christmas and vacation club accounts were subject to the same requirements as savings deposits.

The average reserve requirement on savings and other time deposits before implementation of the Monetary Control Act had to be at least 3 percent, the minimum specified by law.

4. Effective Nov. 2, 1978, a supplementary reserve requirement of 2 percent was imposed on large time deposits of $100,000 or more, obligations of affiliates, and ineligible acceptances. This supplementary requirement was eliminated with the maintenance period beginning July 24, 1980.

Effective with the reserve maintenance period beginning Oct. 25, 1979, a marginal reserve requirement of 8 percent was added to managed liabilities in excess of a base amount. This marginal requirement was increased to 10 percent beginning Apr. 3, 1980, was decreased to 5 percent beginning June 12, 1980, and was eliminated beginning July 24, 1980. Managed liabilities are defined as large time deposits, Eurodollar borrowings, repurchase agreements against U.S. government and federal agency securities, federal funds borrowings from nonmember institutions, and certain other obligations. In general, the base for the marginal reserve requirement was originally the greater of (a) $100 million or (b) the average amount of the managed liabilities held by a member bank, Edge corporation, or family of U.S. branches and agencies of a foreign bank for the two reserve computation periods ending Sept. 26, 1979. For the computation period beginning Mar. 20, 1980, the base was lowered by (a) 7 percent or (b) the decrease in an institution's U.S. office gross loans to foreigners and gross balances due from foreign offices of other institutions between the base period (Sept. 13–26, 1979) and the week ending Mar. 12, 1980, whichever was greater. For the computation period beginning May 29, 1980, the base was increased by 7½ percent above the base used to calculate the marginal reserve in the statement week of May 14–21, 1980. In addition, beginning Mar. 19, 1980, the base was reduced to the extent that foreign loans and balances declined.

5. The Garn–St Germain Depository Institutions Act of 1982 (Public Law 97–320) provides that $2 million of reservable liabilities (transaction accounts, nonpersonal time deposits, and Eurocurrency liabilities) of each depository institution be subject to a zero percent reserve requirement. The Board is to adjust the amount of reservable liabilities subject to this zero percent reserve requirement each year for the next succeeding calendar year by 80 percent of the percentage increase in the total reservable liabilities of all depository institutions, measured on an annual basis as of June 30. No corresponding adjustment is to be made in the event of a decrease. Effective Dec. 9, 1982, the amount of the exemption was established at $2.1 million. In determining the reserve requirements of a depository institution, the exemption shall apply in the following order: (1) nonpersonal money market deposit accounts (MMDAs) authorized under 12 CFR section 1204.122; (2) net NOW accounts (NOW accounts less allowable deductions); (3) net other transaction accounts; and (4) nonpersonal time deposits or Eurocurrency liabilities starting with those with the highest reserve ratio. With respect to NOW accounts and other transaction accounts, the exemption applies only to such accounts that would be subject to a 3 percent reserve requirement.

6. For nonmember banks and thrift institutions that were not members of the Federal Reserve System on or after July 1, 1979, a phase-in period ends Sept. 3, 1987. For banks that were members on or after July 1, 1979, but withdrew on or before Mar. 31, 1980, the phase-in period established by Public Law 97–320 ends on Oct. 24, 1985. For existing member banks the phase-in period is about three years, depending on whether their new reserve requirements are greater or less than the old requirements. All new institutions will have a two-year phase-in beginning with the date that they open for business, except for those institutions that have total reservable liabilities of $50 million or more.

7. Transaction accounts include all deposits on which the account holder is permitted to make withdrawals by negotiable or transferable instruments, payment orders of withdrawal, and telephone and preauthorized transfers (in excess of three per month) for the purpose of making payments to third persons or others. However, MMDAs and similar accounts offered by institutions not subject to the rules of the Depository Institutions Deregulation Committee (DIDC) that permit no more than six preauthorized, automatic, or other transfers per month of which no more than three can be checks—are not transaction accounts (such accounts are savings deposits subject to time deposit reserve requirements.)

8. The Monetary Control Act of 1980 requires that the amount of transaction accounts against which the 3 percent reserve requirement applies be modified annually by 80 percent of the percentage increase in transaction accounts held by all depository institutions determined as of June 30 each year. Effective Dec. 31, 1981, the amount was increased accordingly from $25 million to $26 million; and effective Dec. 30, 1982, to $26.3 million.

9. In general, nonpersonal time deposits are time deposits, including savings deposits, that are not transaction accounts and in which the beneficial interest is held by a depositor that is not a natural person. Also included are certain transferable time deposits held by natural persons, and certain obligations issued to depository institution offices located outside the United States. For details, see section 204.2 of Regulation D.

NOTE. Required reserves must be held in the form of deposits with Federal Reserve Banks or vault cash. After implementation of the Monetary Control Act, nonmembers may maintain reserves on a pass-through basis with certain approved institutions.

Senator HEINZ. Thank you. Our next witnesses are appearing as a panel composed of Dr. Leveson, Dr. Kufman, Mr. Kane, and Dr. Horvitz. Please come forward, gentlemen.

Gentlemen, I understand that you have been requested to keep your statements to 10 minutes. If there are more comprehensive statements that you wish to submit for the record, we will include them in the record in full. We would appreciate your best efforts to observe the 10-minute rule because of other scheduling requirements that we have.

I am going to ask Dr. Leveson to be our first witness. Dr. Leveson.

STATEMENT OF DR. IRVING LEVESON, DIRECTOR OF ECONOMIC STUDIES, HUDSON INSTITUTE, CROTON-ON-HUDSON, N.Y.

Dr. LEVESON. Good morning, Mr. Chairman. We are delighted to be here. I would like to ask my full statement be included in the record and I will summarize it.

Senator HEINZ. Without objection, it is so ordered.

Dr. LEVESON. I would like to discuss three broad issues first. First, the question of the relationship between monetary control and financial deregulation; second, what financial deregulation needs to work; and, finally, suggest the ways in which financial deregulation might be structured.

RELAXING REGULATORY RESTRICTIONS

The balance between relaxing regulatory restrictions and the needs of monetary control has been heavily influenced by concerns about monetary control becoming much more difficult.

I would like to suggest that in fact monetary control will be a good deal easier in the future. We have been going through an extraordinary period in which a trend off rising inflation since the mid-1950's has been abated, a quite difficult feat that was accomplished amid a second oil price shock and a disruptive confrontation between monetary and fiscal policy. It also was accomplished in a period in which interest rate restrictions were causing flows of funds in banks and thrift institutions to move in the opposite direction from flows of funds in the rest of the financial system. With the nearly complete lifting of deposit interest rate restrictions, we can now expect to see that financial flows in depository institutions and financial flows in the rest of the financial system will move in the same direction with changes in savings rates, inflation rates, and demand for funds and monetary policies.

This means we can operate on a core base of deposits in order to more effectively control the entire financial system. At the same time the shift to variable interest rate loans and spread banking means that changes in monetary policies are very quickly transmitted to the rest of the financial system.

So while we often hear about the effects of innovation creating difficulties in monetary control, I see the main difficulties having been associated with the extrordinary period we have been going through and a climate which for technical reasons will mean easier rather than more difficult monetary control from the technical standpoint. Long-term changes in innovation can not be blamed for problems in month-to-month and quarter-to-quarter variations in the degree of monetary control.

To the extent there is some continuing rise in the turnover of money, we can adjust our policies, use additional techniques, changes in reserve requirements, for example, which have not been used for a long time, if necessary, in order to deal with expanding turnover.

But I would recall the fact that the Federal Reserve was particularly concerned that expansion of velocity of money would lead to too strong an economy when it clamped down in 1982 and that raising velocity never came.

So the long-term problem we can deal with by a gradual change in policy.

There has been a reluctance to use changes in reserve requirements as a tool of monetary control because in the past we had to worry about banks leaving the Federal Reserve system, and more recently there have been concerns that with a difference in interest rates caused officially by the lack of payment of interest on reserves, that if we try to use changes in reserve requirements, we would put depository institutions at a competitive disadvantage.

If we want to be able to expand our tool kit to once again be able to vary reserve requirements, then it will make sense to pay interest on reserves, and if financing is a difficulty, there are ways, both in treatment of payment for deposit insurance and tax treatment to raise revenue within the banking system and changing the pricing structure so it is much more favorable to efficient economic management.

WORKABILITY OF DEREGULATION

Now in connection with the workability of deregulation, I think the most salient point is with all of the talk about loosening restrictions, we tend to think of deregulation as allowing an unbridled financial system. But, in fact, there is tremendous agreement among professionals who have studied this issue that deregulation will involve a very marked increase in reporting and supervision and we should not confuse the need for much greater vigilance in a system which has allowed the ability to make more choices with the question of whether or not we are going to dictate the products and market that firms can operate in. There is a great tendency to underestimate potential benefits of deregulation. We have an economy which is going to need freedom to solve extraordinarily difficult problems and particularly problems involving capital formation and risk taking.

There is a tendency to think about the benefits of reduced regulation in terms of benefits to the consumer and to ignore the less visible but potentially even more important impact on the ability to finance industry as we allow new forms of financing and institutional arrangements to develop in unshackled ways. Deregulation should be broad based. We can maintain a sound system for monetary control by regulating insured deposits. There have been many suggestions about how to define a bank. Commercial loanmaking goes on without regulation very effectively, as we see for example in the success of GE Credit Corp. and does not require the kinds of regulation we impose on the banking system.

Check writing is in the early stages of being overtaken in importance by electronic funds transfer, which occurs and will occur in the future in ways that are activated by credit and debit cards, with and without microprocessors, by home terminals, by point of sale terminals, electronic cash registers, by cash management, computers and [illegible] treasurer's offices and a host of devices. Trans[illegible] out electronically and the notion that we [illegible] for defining a bank will become obsole[illegible] that we fall back on insured deposit [illegible]nition of a bank and for the central func[illegible]

Fi[illegible]states should continue to have the opportun[illegible]ties that are not now required to be in a holding company [illegible] conduct those activities outside of a holding company structure. That is, I envision a two-tier system in which many activities will be carried out within a holding company and they will be service corporations for those functions which we choose to separate from the insured portion, from the controls, deposits from the point of view of monetary policy, we will have separate service corporations within a holding company.

There are many other financial service activities which can well be carried out by a financial conglomerate without having to place it in the holding company at all.

Within the holding company structure, I would support the notion of carrying out an investment banking type activity within a separate service corporation. It is essential that banks be allowed to take equity positions. We are going to move more into large-scale capital financing projects which require a mixing of equity and debt in new types of arrangements which require innovative structuring of the timed flow of payments. With hard real interest rates, we want to be able to defer payment the way equity positions allow you to do. We need risk-pooling in a variety of new forms, some organizational structures are already provided, including the bankers' banks in the Garn-St Germain Act. But I think we have to allow mu[illegible]ability for banks to participate in investment bank[illegible]. This can be done with appropriate limits on the siz[illegible]size of a company's securities which it takes, it [illegible]itations on the proportion of a bank's assets wh[illegible]other restricted forms. It can be done with lim[illegible] financing which a bank can be engaged in [illegible]deals.

But there [illegible] to prevent banks from getting involved very substantially in innovative packages of corporate financing activities that can help keep the economy moving. Interstate branching restrictions should be subject to full and immediate removal. We should use [illegible] McFadden and Douglas routes, because a limitation to ho[illegible]panies will not give us the full benefits of competition and [illegible]ation.

Finally, I caution against confusing the need for regulation with the need for vigilance. The Penn Square, Butcher, Baldwinn, and even some of th[illegible]tional debt problems arose in an environment of [illegible]tion. The most serious problems were reporting and supervision. We must be willing to supervise and at the same time allow firms to fail. That means accepting greater discomfort of market discipline if we wish to get the full benefits of competition and innovation.

Thank you.

[The complete statement of Mr. Leveson follows:]

Testimony of Dr. Irving Leveson, Director of Economic Studies, Hudson Institute before the Senate Banking Committee on the Condition and Structure of, and Competition within, the Domestic Financial Services Industry, June 21, 1983.

1. Controlling Money Wouldn't Stop Financial Deregulation

The [illegible] regulatory restrictions and the needs of monet[illegible] influenced by complaints from the Federal Reserve [illegible] has become more difficult. In [illegible] difficult in the future.

[illegible] never technical but rather political. [illegible] concerns about where the economy would [illegible] would be on domestic and international bo[illegible] continue to abate.

Many [illegible] expect and were not willing to accept the large social [illegible] recession agree that is necessary to follow through to obtain the benefits of reduced inflation, once most of those costs have been incurred. Political will cannot be taken for granted but it is reasonable to expect significantly greater efforts to control inflation in the current recovery than in the last.

Monetary control has been unusually difficult in the last several years but that has not primarily been the result of deficiencies in control mechanisms. Since the Humphrey Hawkins Act elevated fighting inflation to equal status with reducing unemployment in 1978, monetary actions have abated a rising trend of inflation that has persisted since the mid-1950's. This extraordinary feat was accomplished in the face of the second oil price shock and disruptive conflicts between monetary and fiscal policy.

Monetary control was made technically difficult in a period of high interest rates by restrictions on interest rates paid to depositors and lenders. Interest rate restrictions caused credit volumes to move in opposite directions in institutions taking deposits subject Regulation Q vs. the rest of the financial system. It also caused large scale withdrawal of credit from some sectors of the economy. The March 1980 credit controls further exacerbated this problem.

With the lifting of interest rate ceilings virtually complete, credit volume in deposit taking institutions can now be expected to move in the same direction as credit in other parts of the financial system when there are major changes in savings rates, credit demands, inflation or monetary policy. This will make the task of monetary control easier in the years ahead, and it will mean that the Federal Reserve can effectively control credit throughout the economy by rules applied to banks and thrift institutions.

Moreover, in an era of variable interest rates and spread banking, restraint is passed on quickly, making monetary control more effective.

There still remains the issue of whether technological and institutional changes are increasing monetary turnover, making it more difficult for the Fed to control inflation by operating on flows which are formally part of the money supply. Let us remember that one reason the 1982 economic decline was so severe was that the Federal Reserve Board was afraid that there would be a large rise in the velocity of money as a result of rapid financial innovation and so it kept credit tight. The rise never came.

There is no reason to expect that variations in money supply growth caused by financial innovation will be so large as to have serious consequences for month-to-month or quarter-to-quarter money management. Longer term effects can be dealt with by a variety of actions, including changes in reserve requirements. The reserve requirement tool that has not been used for many years, first because of fears banks would leave the Federal Reserve System, and then because of hesitancy during the transition to uniform rules under the Monetary Control Act.

There may be reluctance to raise reserve requirements in the future because of concern that it would make banks and thrifts less competitive with money funds. That is a problem which arises, however, only because banks do not receive interest on reserves. If interest were paid, reserve requirements could be raised without having serious competitive effects among financial sectors. Payment of interest could be financed by changes in the tax treatment of banks and thrifts in ways which would also move toward equal treatment among sectors.

If existing tools were not sufficient, it would be possible to place reserve requirements on some funds held outside of depository institutions or to broaden the definition of depository institutions to include other financial sectors. However, such extensions of regulation may be especially inappropriate right after the lifting of Regulation Q, and may never be necessary. They should not be considered until we have operated again in an environment of flexible reserve requirements, and if necessary, interest on reserves, to make it work.

The implication is that decisions about financial regulation should not be dominated by needs of monetary control and financial deregulation should be allowed to proceed rapidly.

2. Deregulation will Work

What then is the nature of financial deregulation which should be sought? First we should seek at least as much guidance for financial firms from the marketplace as from regulation. Lest that be misunderstood, this is a decision which will require more reporting and supervision rather than less, but it is one which will allow economic agents far more freedom to choose which markets to enter and which products to offer.

The value of the discipline of the marketplace is not fully appreciated.

We have become too used to a market in which firms have not been allowed to fail. While we will always require basic guarantees to depositors, those guarantees should not be so extensive as to present competition. We step in to prevent failures when only one-sixth of bank assets are beyond the $100,000 insured limit. Those typically are funds of affluent individuals and small businesspersons that are perfectly capable of diversifying risks and buying insurance.

It is ironic that regulators and even much of the public talk so much about the possibility of loss of competition with deregulation during the most intensively competitive period in decades. Much of industry fears the discipline of the marketplace because of the changing fortunes of various competitors which Darwinism innovation and succession entails.

There will be significant failures, but these will lead to prudence for a generation, as occurred with the Real Estate Investment Trusts. The discipline of the market will combine with increased supervision, continuation of some regulation and the possibility of some later reimposition of regulation to guide the system through an extremely dynamic period.

The financial system of the future will have to find new ways to foster capital formation and risk taking. It will have to have the freedom to continue to solve the extraordinary problems posed by a new economic environment. In order to prepare for this we should not get bogged down in process, but should let economic agents determine what arrangements can deal with the problems that present themselves.

3. Deregulation Should Be Broad-Based

We have been struggling with definitions of banks that include deposit-taking, federal insurance, check-writing, commercial loan-making and other criteria. Bank robbers, when asked why they rob banks, often have answered that it was because that is where the money is. It should not be different for bank regulation.

Commercial loan-making goes on in many places without regulation and with substantial benefits to the economy, as the success of G.E. Credit illustrates.

Check writing is at early stages of being overtaken in importance by electronic funds transfer, activated by credit and debit cards (with and without micro processors) telephone calls, instructions from home computers, inputs from point of sale terminals and directions from cash management computers in corporate offices. The transaction criterion for determining a bank will serve less and less well as the basis for control. But banks are where the money is. We can maintain a sound system for monetary control by regulating federally issued deposits, and if deposits outside of banks and thrifts do not move together with deposits in depository institutions, we can subject them to some of the same rules.

The rules that apply to deposit-taking need not apply to commercial and consumer loans, insurance sales, securities sales, underwriting or any of the other financial functions which abound. It would be useful to require that underwriting activities be based in separate subsidiaries of bank and thrift holding companies because that will somewhat reduce the potential for abuse, and separate the funds to which monetary restrictions and deposit insurance apply. But there is little reason to restrict holding companies from providing a broad range of services on a substantial scale.

Moreover, financial service conglomerates should continue to have the opportunity to conduct activities not now required to be in a holding company, outside the holding company structure. Thus, a financial service conglomerate could operate corporate and consumer lending arms outside of any bank holding company, have a bank holding company which owns a bank, and also have them the holding company, a service corporation that underwrites securities.

It is important that we allow bank holding company service corporations to offer a wide range of investment banking services. The nation will need large amounts of capital and more extensive mechanisms for risk-pooling in the years ahead. The banking system can add much to the capabilities of the investment banking community. The extent of bank underwriting can be limited as to the share of a corporation's issue and assets it can own, the share of its assets that can be in a single security or in all securities, or the forms of financing in which it is allowed to participate. But it is essential that banks be allowed to take far greater equity positions to facilitate capital formation and risk-taking by industry.

With regard to the separation of banking and commerce, I do not see any reason for preventing thrifts from being owed by commercial and industrial firms as long as they are limited to perhaps one fourth of their assets in corporate loans. "Nonfinancial" firms should not be precluded from extensive sales and service activities, other than underwriting. As for more extensive combinations of securities underwriting and commercial banking with commercial and industrial activities, we can afford to wait.

Interstate branching restrictions should be subject to full and immediate removal. There should be no limitation of branching to bank holding companies. Repeal of both McFadden and Douglas restrictions will permit the greatest competition and innovation.

Finally, I must caution again against confusing a need for regulation with a need for vigilence. The Penn Square, Butcher, Baldwin United and even the international debt problems arose amid substantial regulation. They were primarily problems of reporting and supervision. We must be willing to accept the discomfort of greater market discipline if we are to get the full benefits of competition and innovation.

Senator HEINZ. Thank you, Mr. Leveson.

Our next witness is Dr. George Kaufman. Dr. Kaufman.

STATEMENT OF GEORGE G. KAUFMAN, PROFESSOR, DEPARTMENT OF FINANCE, LOYOLA UNIVERSITY OF CHICAGO, CHICAGO, ILL.

Mr. KAUFMAN. Thank you, Mr. Chairman.

I am happy to participate in this committee's important function of providing oversight of the financial system. It is redundant for me to say that banking and the financial services industry have changed radically in recent years. Indeed, they have probably changed more in this period than in the entire period and since banks first developed from goldsmiths.

The forces driving these changes are also well known. The dramatic improvements in technology have reduced the cost and increased the speed of collecting, processing, and transferring information and funds, and the equally dramatic changes in the economic environment have increased nominal personal wealth, on the one hand, and the opportunity cost to the owners of holding this wealth idle as interest rates have increased, on the other. These forces have clashed head on with legislation and regulation that were imposed to deal with the problems of an earlier era, primarily the depression years of the 1930's when the overriding public concern was with safety and preventing additional bank failures. In this era, legal barriers were imposed that segmented the industry and its products, and restricted price competition. The technology of communications and information processing was not sufficiently advanced at that time to permit these barriers to be bypassed efficiently nor were the economic incentives to do so sufficiently strong. When these conditions changed, the regulations were increasingly bypassed. The marketplace hardly waits for changes in regulations.

IMPLICATIONS OF CHANGES FOR EFFICIENCY

What are the implications of these changes for the efficiency of the financial system in serving its customers and the country as a whole? Is there a need for further deregulation, reinforcing the existing regulations, or imposing new regulations? I believe that in a free market providers of services are the best judges of what customers want. If the providers are right, they are rewarded; if they are wrong, they are penalized and may be forced to leave the field of competition. To evaluate financial regulation, it is necessary to understand why we regulate banking differently from other industries. We do so primarily for three reasons other than the control of the money supply:

One, the failure of individual depository institutions that operate on a fractional reserve basis may spread quickly to other institutions, producing a decline in aggregate money and credit that is more damaging to the community than reductions in the output of other industries.

Two, concentration and monopoly of money and financial services is viewed as more important than concentration or monopoly in other industries, and

Three, a substantial potential exists for conflicts of interest.

These three reasons were sufficiently important to justify widespread regulation of financial services in the past and, indeed, in almost all countries and should not be shrugged off cavalierly today. As the recent experience of banks and thrift institutions indicates, the safety of the banking system remains an important private and public concern. The main line of protection here, of course, is deposit insurance, and I applaud the reexamination of deposit insurance mandated by the Garn-St Germain Act of 1982 and hope that this issue will be part of this committee's area of inquiry.

It is because deposit insurance, unlike almost all other forms of insurance, is currently priced independently of the riskiness of the insured bank that many of the expanded regulations regarding safety are justified. Thus, continued deregulation requires the introduction of some form of explicit risk-sensitive premium structure.

The fear of financial concentration is particularly strong in the United States. This is reflected in the occasional prohibition of banking in certain geographical areas in the early days of our history and in the restrictions on branching that exist even today. It is also reflected in the recommendation of the recent American assembly symposium that institutions that offer deposits should not be able to offer nonfinancial services and conversely, that is, a separation of finance and commerce. On the other hand, it is important to note that size and scope by themselves do not guarantee financial success nor the ability to drive out other, smaller or specialized institutions. This is clearly the evidence from banking and also from both nonregulated industries, such as the grocery industry, and industries undergoing deregulation, such as the airline and trucking industries.

GENERAL ANTITRUST LAWS SHOULD BE EXAMINED

General antitrust laws should be examined to see whether they are able to deal adequately with financial firms and products, including combination of banks and nonbanks. If so, then it should be possible to remove similar regulations aimed especially at banking such as the Bank Merger Act and interstate branching restriction. If not, it may still be best to expand the general antitrust regulation than to maintain specialized banking legislation. This area is of such importance that it warrants a large-scale but not lengthy study and possibly a moratorium of some bank-nonbank combinations until this study is completed.

Conflicts of interest may be different today than in the 1930's and may be easier to detect because of the disclosure regulations of the Securities and Exchange Commission that were not in effect earlier. But the potential still exists. Indeed, given the increasing combinations of previously segmented financial services firms that offer complimentary products, such as insurance companies and investment banks, the potential for conflicts has spread to many more firms than just commercial and investment banks on which the Glass-Steagall Act focuses. As the American Assembly recommended, the restrictions of the Glass-Steagall Act should be replaced by provisions addressing the problems of concentration of power and conflicts of interest in all financial services, not just banking.

My recommendation to you is to continue to monitor and study the forces that underlie the ongoing changes in the financial services industry and to draft a regulatory framework that is appropriate and efficient for today's world and, hopefully, also for tomorrow's.

[The complete statement follows:]

TESTIMONY BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

U. S. SENATE

June 21, 1983

George G. Kaufman

(John Smith Professor of Banking and Finance)
(Loyola University of Chicago)

I am happy to participate in this committee's important function of providing oversight of the financial system. It is redundant for me to say that banking and the financial services industry have changed radically in recent years. Indeed, they have probably changed more in this period than in the entire period and since banks first developed from goldsmiths.

The forces driving these changes are also well-known. The dramatic improvements in technology have reduced the cost and increased the speed of collecting, processing, and transferring information and funds, and the equally dramatic changes in the economic environment have increased nominal personal wealth, on the one hand, and the opportunity cost to the owners of holding this wealth idle as interest rates have increased, on the other. These forces have clashed head-on with legislation and regulation that were imposed to deal with the problems of an earlier era, primarily the depression years of the 1930's when the overriding public concern was with safety and preventing additional bank failures. In this era, legal barriers were imposed that segmented the industry and its products, and restricted price competition. The technology of communications and information processing was not sufficiently advanced at that time to permit these barriers to be bypassed efficiently, nor were the economic incentives to do so sufficiently strong. When these conditions changed, the regulations were increasingly bypassed. The marketplace hardly waits for changes in regulations!

What are the implications of these changes for the efficiency of the financial system in serving its customers and the country as a whole? Is there a need for further deregulation, reinforcing the existing regulations, or imposing new regulations? I believe that in a free market providers of services are the best judges of what customers want. If the providers are right, they are rewarded; if they are wrong, they are penalized and may be forced to leave the field of competition. To evaluate financial regulation, it is necessary to understand why we regulate banking differently from other industries. We do so primarily for three reasons:

1. The failure of individual depository institutions that operate on a fractional reserve basis may spread quickly to other institutions, producing a decline in aggregate money and credit that is more damaging to the community than reductions in the output of other industries,
2. Concentration and monopoly of money and financial services is viewed as more important than concentration or monopoly in other industries, and
3. A substantial potential exists for conflicts of interest.

These three reasons were sufficiently important to justify widespread regulation of financial services in the past and, indeed, in almost all countries and should not be shrugged off cavalierly today. As the recent experience of banks and thrift institutions indicates, the safety of the banking system remains an important private and public concern. The main line of protection here, of course, is deposit insurance, and I applaud the reexamination of deposit insurance mandated by the Garn-St Germain Act of 1982 and hope that this issue will be part of this committee's area of inquiry.

The fear of financial concentration is particularly strong in the United States. This is reflected in the occasional prohibition of banking in certain geographical areas in the early days of our history and in the restrictions on branching that exist even today. It is also reflected in the recommendation of the recent American Assembly symposium that institutions that offer deposits should not be able to offer nonfinancial services and conversely, that is, a separation of finance and commerce. On the other hand, it is important to note that size and scope by themselves do not guarantee financial success nor the ability to drive out other, smaller or specialized institutions. This is clearly the evidence from banking and also from both nonregulated industries, such as the grocery industry, and industries undergoing deregulation, such as the airline and trucking industries.

Conflicts of interest may be different today than in the 1930's and may be easier to detect because of the disclosure regulations of the Securities and Exchange Commission that were not in effect earlier. But the potential still exists. Indeed, given the increasing combinations of previously segmented financial services firms that offer complimentary products, such as insurance companies and investment banks, the potential for conflicts has spread to many more firms than just commercial and investment banks on which the Glass-Steagall Act focuses. As the American Assembly recommended, the restrictions of the Glass-Steagall Act should be replaced by provisions addressing the problems of concentration of power and conflicts of interest in all financial services, not just banking.

My recommendation to you is to continue to monitor and study the forces that underlie the ongoing changes in the financial services industry and to draft a regulatory framework that is appropriate and efficient for today's world and, hopefully, also for tomorrow's.

Senator HEINZ. Thank you, Mr. Kaufman. Mr. Kane.

STATEMENT OF EDWARD J. KANE, REESE PROFESSOR OF ECONOMICS AND FINANCE, OHIO STATE UNIVERSITY, COLUMBUS, OHIO

Mr. KANE. Thank you, Mr. Chairman. I'd like to ask first that my written statement be entered in the record.

Senator HEINZ. Without objection, so ordered.

REREGULATION

Mr. KANE. Thank you. My written statement makes three points about innovation and what I call reregulation. Reregulation is the major subject of this committee today.

First, reregulation is a competitive process in which State and Federal legislators and State and Federal regulatory agencies compete with each other for three things: jurisdiction, tax dollars, and budget funds.

Second, it is useful to think of changes in a regulated institution's organizational form as structural arbitrage. Such actions as charter switches and establishing nonbank banks occur to permit an institution to pursue opportunities for profit that would not otherwise be open to it.

These two points flow together because structural arbitrage both fuels and feeds upon competitive reregulation.

Third, and most important, structural arbitrage is progressively undermining the viability of the inherited system of the Federal deposit insurance. Defenders of the status quo of Federal deposit insurance remind me of the two government building inspectors who accidentally tumbled off the roof of the 60-story building. As they passed the windows of each of the top 50 floors, they loudly reassured each other and the building's occupants, "So far, so good."

My point is whatever good the deposit insurance system has accomplished in the past, its momentum is propelling it in the direction of a bureaucratic disaster. Unless market discipline is reimposed on deposit institution risk taking, the deposit insurance bureaucracy is eventually going to go splat.

The policy of routinely bailing out of all but the most disastrously troubled banks and S&L's has induced a massive substitution of equity in the form of deposit insurance guarantees for private funds in deposit institutions. Through these guarantees, the Federal Government has become the leading supplier of equity funds through deposit institutions. The Nation appears to be unconsciously trodding a backdoor path to the de facto nationalization of the deposit institution industry. This would be an unintended and undesired nationalization that is exemplified by Government operation of what are called Phoenix combinations of failed S&L's. To reverse the momentum in the system, incentives to invest private equity capital in deposit institutions must be restored.

What's wrong with the inherited system? The main problem is that currently Federal deposit insurance fully guarantees an institution's deposit accounts up to $100,000 per account holder without charging an appropriate fee for those guarantees. The guarantees are supported by explicit premiums of one-half of 1 percent of the total deposits booked at domestic offices. Now this pattern of explicit pricing is not sensitive to differences in the market volatility of interest rates or in the leverage and the asset risk of these institutions. As a result, FDIC and FSLIC personnel must regulate client risk taking directly. We can view capital adequacy requirements and backup regulatory penalties for excessive risk taking as implicit premiums that agency managers vary to control these and other bureaucratically recognized forms of risk taking.

Three things are wrong with such a coverage and pricing system. First, it is allocationally inefficient. By mispricing risk, it wastes resources. Second, it is distributionally unfair. It forces conservatively managed deposit institutions to underwrite their higher flying competitors. Third, it fosters financial instability. It subsidizes deposit institution risk-taking most when markets are most volatile and loads the burden for financing this subsidy onto both conservatively managed deposit institutions and taxpayers in general. Because this premium structure subsidizes unregulated forms of risk-bearing, it leads to a continual search for and expansion of new forms of risk-taking. It also leads bureaucratic conceptions of operative categories of deposit institution risk-taking to play the pivotal role in making the system work.

Federal deposit insurers need not suffer losses if they are quick to adapt their regulatory policies to emerging problems. But bureaucrats are inherently slower in responding to emerging forms of risk than private insurers would be. One reason is that politically appointed agency heads typically have short horizons and political constraints overlay an agency's strictly economic interests in the decisions it makes. This leaves Government bureaucracies notably low in adaptive efficiency—in the ability to respond to change. This inherent weakness makes it unwise, in a financial services environment changing as rapidly as ours is today, for an agency to follow policies that thrust its adaptive efficiency in protecting its economic interests into a key role. Such an agency ends up operating out of its element, much like a fullback-oriented football team that is forced to play catchup ball in a big game. I apologize if this analogy seems more vivid to a professor from Ohio State University than it does to the members of this committee.

RISK-TAKING INCREASES FRAGILITY OF OUR FINANCIAL SYSTEM

The deposit insurance subsidy risk-taking has greatly increased [illegible] fragility of our financial system. To cut back voluntary risk-[illegible] is necessary not only to reprice but also to redesign the [illegible] system of deposit insurance coverage. The FDIC and [illegible] must develop incentive-compatible insurance contracts and they must price them fairly. In a world in which deposit institutions are highly levered and interest rates are highly volatile, systematically underpricing deposit insurance guarantees encourages deposit institution managers to position themselves on the edge of financial disaster. Metaphorically, deposit insurance authorities are paying deposit institution managers to disco on window ledges of financial skyscrapers all over the country. The task of reregulation is to get those managers back inside those walls before it becomes too late.

Our goal must be to confront institutions whose risk-taking imposes unacceptable risks with a combination of reduced coverages and increased fees sufficient to move them back from the brink. This involves getting the FDIC and FSLIC to act more like private insurers so that they better protect their and the taxpayers' interest and make uninsured creditors and stockholders bear more of the risk inherent in the deposit institution's operations.

The reregulation I have in mind must include some or all of six basic changes in the Federal deposit insurance contract. My proposal constitutes something akin to a Chinese menu. It has six columns of nutritious policy options. The first is full disclosure of adverse information. Reinstituting market-value accounting for deposit institution loans and investments would be a very good thing. It can be justified as a cost-effective scheme for raising the implicit premium on deposit insurance in what would be a risk-sensitive way. The most attractive aspect of this approach is that it lets market opinion act as the arbiter that conducts risk assessments and sets risk premiums. In a world where market-value losses are not papered over by book-value accounting, deposit institution managers who pursue unregulated risks know that they face quicker and more extensive damage to their careers when and if these risks go badly.

Investors in deposit institutions and depositors that are less than fully insured deserve best efforts estimates of the risk exposure and changing market value of the assets and liabilities that deposit institutions book. To produce such estimates, one need employ concepts no more sophisticated than present-value calculations. Hand held calculators now let any literate person carry out present-value calculations. The discount rates needed as input into these calculations can be collected from secondary markets and, where necessary, supplemented by insurer-arranged auctions of similar assets. Such auctions could be arranged today, for instance, with developing countries' loans that people are so worried about, if authorities wanted to ascertain their market value. My impression is they don't want to know their market value.

The second component involves recalibrating insurance coverages. The pattern of coverages must be altered to generate information on clients' own perceptions of the benefits from covering different kinds of portfolio risks and their willingness to pay for alternative forms of coverage. As a strategy for assembling information with which to improve the rating process I have in mind three changes in contract provisions.

CHANGES IN CONTRACT PROVISIONS

First is lowering the basic coverage for account holders to—say—$10,000, with future limits indexed for inflation. Second is instituting differential pricing for successive layers of optional of supplementary coverages. These could be offered in $10,000 slices, with these prices adjusted according to market principles. Third is introducing provisions for deductible and coinsurance elements into this supplementary coverage. These elements could include such old-fashioned provisions as making stockholders of failed deposit institutions pay additional penalties.

The third element in my Chinese menu is risk-rated explicit premiums. George Kaufman spoke about those just a minute ago. This change is needed to relegate implicit premiums on recognized forms of risk-taking to a lesser role. All observers acknowledge that this is a very hard task. There's no question that it's a hard task. But it is not an impossible task. Continuing to run a system in which insurance is underpriced as badly as it is today is simply impossible. We will be heavily penalized for this effort if we continue. [illegible] because pricing is a hard task, it seems dangerous to [illegible] the function wholly to Government officials. This leads to [illegible] fourth point in my program.

My fourth suggestion is to provide meaningful opportunities for private competition in deposit insurance. To introduce competitive discipline, it is necessary to provide opportunities for private firms to issue or to reinsure at least some layers of supplementary deposit insurance coverage. Authorities must invite into the contract design and contract pricing process decisionmakers whose only stakes are economic—parties whose jobs and firms can and will be wiped out if they issue contracts which fail to make it each client's own best interest to keep its risk exposure under control.

The fifth point of the program is creating expanded opportunities for deposit insurance agencies to manage their own risk exposure. Deposit insurance agencies need enhanced rights to take timely action to cancel insurance coverage or to foreclose on the bank's charter before an institution's net worth is exhausted. The point is to stop institutions that are insolvent de facto from being permitted to make outlandish end-game plays with what is ultimately taxpayers' money.

The sixth point in the program is to place statutory constraints on authorities' ability to bail out insolvent deposit institutions and deposit insurance companies. Deposit insurers must make their implicit guarantees of what are supposed to be uninsured liabilities less perfect. This requires politicians to tie themselves to the mast of economic discipline so that they can resist the temptation of opportunities to bail out individual institutions when they get in trouble. First, deposit insurance agencies should leave the short-term responsibility for stabilizing the financial system wholly in [illegible] Reserve, acting in its capacity as lender of [illegible] should not be construed to form [illegible] Deposit Insurance agencies. Second, [illegible] a bona fide crisis that could be de- [illegible] 10 percent of aggregate deposit in- [illegible] involved in failures within the last 12 [illegible] Reserve's capacity for bailing out insolvent institutions needs to be constrained.

This concludes my statement. I thank you.

Senator **Heinz**. Thank you.

[The complete statement follows:]

STATEMENT FOR U.S. SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

Edward J. Kane
Reese Professor of Banking and Monetary Economics
Ohio State University
June 21, 1983

Financial reregulation is cooperating with competitive forces to destroy longstanding patterns of institutional specialization in American capital markets. Increasingly, fast-growing and high-profit financial institutions are those that spread their operations into broader geographic regions and additional product lines.

Although it is natural for observers to resent the amount of relearning and conceptual restructuring that the desegmentation of the financial-services industry requires, it is important to see that what is ultimately going on is the expansion of economically efficient producers at the expense of inefficient ones. Even in a regulated industry, the structure of competition adapts -- through entry, exit, and gains and losses in the market shares of individual competitors -- to permit products to be produced and delivered at minimum average resource cost. Regulation tends to slow this process, while technological change helps to accelerate it. The breakdown of the inherited segmentation of financial competition reflects the technological emergence of what are called economies of scope: opportunities to reduce the costs of financial services by producing these services in combination rather than on a stand-alone basis.

Telecommunications and computer record-keeping create obvious economies of scope in executing and keeping track of varied types of customer transactions. These scope economies lie at the heart of the rapid progress toward homogenization of function observed for such traditionally distinct financial institutions as commercial banks, thrift institutions, brokerage firms, and insurance companies and even for nonfinancial firms engaged in data processing and communications. The quest for productive efficiency leads managers of these firms to find ways to expand their operations and product lines into one another's pre-existing domains.

1. Competition Among Regulators

In the face of technological change, competition among financial-services firms is enhanced by competition among regulators. Regulated players' ability to switch regulatory affiliations is an example of what we may call structural arbitrage: changes in an institution's organizational form that permit it to pursue opportunities for profit that the old form foreclosed. This arbitrage puts economic pressure on bureaucrats to alleviate the burdens that inherited regulations would in a changing marketplace otherwise impose on regulated firms and their customers. Duplicate regulatory functions and overlapping administrative boundaries provide opportunities for regulated firms to shrink the domains (and therefore the budget resources) of regulators whose response to the evolving needs of the institutions or markets they supervise is habitually short-sighted or inflexible.

With the liabilities of deposit institutions backed up by a system of federal deposit insurance that does not explicitly price default, maturity, or leverage risk, federal deposit-institution regulators must concern themselves with limiting risk-taking by insured firms. This concern leads them to constrain and supervise a deposit institution's position in futures contracts as well as risky activities undertaken by any holding-company affiliates. Conflicts over regulatory turf are heightened by cross-industry merger activity and by product-line expansion by brokerage and deposit firms. The ongoing robotization and electronification of systems for producing and delivering financial services is increasingly extending the boundaries of regional competition and sweeping the activities of individual deposit institutions into new states and into the [illegible] of securities and futures-market regulators. These same forces are simultaneously thrusting the activities of securities and futures-market firms into the orbits of state and federal deposit-institution regulators.

These changes create incentives for individual state legislatures to compete against each other in relaxing the regulatory rules under which state-chartered banks and holding-company affiliates can play in their state. Banking lobbies are able to hold out to a cooperative legislature a promise of jobs, tax revenue, and crisis-free absorption of failing institutions in exchange for portfolio powers that Congress has not yet seen fit to give them.

Bureaucratic competition for regulatory jurisdiction is part and parcel of the American way. Although it makes for messy organization charts and an over-abundance of government agencies, this form of competititon improves the long-run adaptive efficiency of government regulatiuon. It is a manifestation of the constitutional system of checks and balances that keeps political power from being exercised arbitrarily and assures us that future patterns of government regulation must ultimately mirror long-run equilibrium patterns of institutional and interinstitutional competition.

However, over the short run, structural arbitrage can generate bureaucratic crisis. Today, bureaucratic competition for jurisdiction is leading various state and federal regulators to promote forms of structural arbitrage that undermine the viability of the inherited system of federal deposit insurance. Although this arbitrage is vastly increasing the risk exposure of the FDIC and FSLIC, political pressures and competition from other regulators have so far prevented the deposit insurance agencies from bringing these new risks under administrative control.

2. Structural Arbitrage and Deposit-Insurance Risk Exposure

Defenders of the status quo in federal deposit insurance remind me of the two government bureaucrats who accidentally tumbled off the roof of a 60-story building. As they passed the windows of each of the top 50 floors, they loudly reassured each other and the building's occupants, "So far, so good." My point is that, whatever good the deposit-insurance system has accomplished in the past, its momentum is propelling it in the direction of a bureaucratic disaster. Unless market discipline is reimposed on deposit-institution risk-taking, the deposit-insurance bureaucracy is eventually going to go SPLAT.

I want to emphasize that I am not predicting a crisis for deposit-institution customers. Although such an event is not totally out of the question, the politics of central banking and deposit-institution regulation make it unlikely. Subsidized emergency loans to threatened institutions provide a politically quick and easy way to arrest a systemic run on deposit institutions were one to get under way. But repeated doses of bailout medicines run the risk of cumulating into a *de facto* nationalization of the deposit-institution industry.

a. What's Wrong with the Inherited System? Why isn't It Politically and Economically Sustainable?

Currently federal deposit insurance fully guarantees an institution's deposit accounts up to $100,000 per accountholder, with accounts held singly and jointly being afforded a separate insurance status. These guarantees are supported by *explicit* premiums of 1/12 of one percent of total (insured and uninsured) deposits booked at domestic offices. Because this pattern of explicit pricing is not sensitive to differences in leverage or asset risk, client risk taking must be regulated directly. We can view regulatory penalties for excessive risk-taking and back-up capital-adequacy requirements as implicit premiums that agency managers vary to control these and other bureaucratically *recognized* forms of risk-taking.

Three things are wrong with this coverage and pricing system. First, it is allocationally inefficient (an economist's mortal sin). It wastes resources. Second, it is distributionally unfair (a political scientist's mortal sin). It forces conservatively managed deposit institutions to underwrite their higher-flying competitors.

Third, it fosters financial instability (a politician's nightmare). It subsidizes deposit-institution risk-taking and loads the burden for financing this subsidy onto both conservatively managed deposit institutions and taxpayers at large. Because this premium structure subsidizes unregulated forms of risk-bearing, it leads to a continual search for (and expansion of) new forms of risk-taking. It also leads bureaucratic conceptions of operative categories of deposit-institution risk-taking to play the pivotal role in making the system work.

Federal deposit insurers need not suffer losses if they are quick to adapt their regulatory policies to emerging problems. But bureaucrats are inherently slower in responding to emerging forms of risk than private insurers would be. Politically appointed agency heads typically have short horizons and political constraints overlay an agency's strictly economic interests in the decisions it makes. This leaves government bureaucracies notably low in adaptive efficiency. This relative weakness makes it unwise for an agency to follow policies that thrust its adaptive efficiency in protecting its economic interests into a key role. Such an agency ends up operating out of its element, much like a fullback-oriented football team that is forced to play catch-up ball in a big game. (I apologize if this analogy seems more vivid to a professor from Ohio State University than it does to the typical reader).

For reasons that seem illogical to me, generally accepted accounting principles do not require that the value of unfunded guarantees be placed on insureds' and insurers' balance sheets. Because neither clients nor agencies book this value, it has grown far bigger than is generally recognized and has slipped administratively out of control. Systematically underpricing deposit insurance guarantees has induced a massive and ongoing substitution of equity in the form of deposit-insurance guarantees for private equity in deposit institutions. Through these guarantees, the federal government has become the leading supplier of equity funds to deposit institutions. The nation appears to be trodding a back-door path to the *de facto* nationalization of the deposit-institution industry, an unintended nationalization that is symbolized by government operation of phoenix combinations of failed S&Ls. To reverse the process, incentives to invest private capital in deposit institutions must be restored.

b. Updating Regulatory Conceptions of Operative Deposit-Institution Risk

For deposit institutions, failure is best defined as a regulator-induced cessation of independent operations. Deposit institutions fail because risk-taking is their very business. The more risk (net of diversification) that a deposit institution takes on, the higher its return but also the greater its chance of failure. A problem institution's potential or actual insolvency contributes to its failure, but the decision to close out its existence rests with supervisory authorities who focus on book values rather than on market values *per se*.

To show how rapidly the relevant risks of deposit-institution operation are changing, Figure 1 attempts a taxonomy of banking risk. The basic distinction is between the risks a bank incurs as an institutional investor and those it incurs as a producer of financial services. Of the nine forms of risk distinguished in the figure, four have increased in importance dramatically during the last four years: interest-volatility risk, subsidiary risk, regulatory risk, and technological risk. During the same interval, making loans to governments and government-sponsored firms in less-developed and Eastern European countries exploited a category of credit risk that (perhaps for political reasons) was too long left unregulated. Growth in these risks has been stimulated by regulatory lags in restraining deposit-insurance subsidies to unregulated forms of risk.

3. Insurance Subsidies are Shifted

Ironically, although deposit-insurance subsidies provide short-run benefits for aggressive institutions, they do not permanently enrich the deposit-institution

FINANCIAL RISK

Risk of breakdowns in the firm's system for encouraging internal integrity	Risk of losses passed along from affiliated (including subsidiary) institutions	Liquidity Risk: the risk that servicing an unpredictable surge in net clearings and cash withdrawals will impose substantial expenses on the firm	Credit Risk: the risk that borrowers will default on promised repayments	Interest-rate Risk: the risk that changes in the level of market interest rate will affect the market value of assets and liabilities differently	Foreign-Exchange Risk: the risk of unfavorable fluctuations in the value of assets and liabilities denominated in foreign currencies

SERVICE-FACILITY RISK

Risk that the firm will operate at less than maximum efficiency	Risk that unforeseen regulatory action will impair the firm's profitability	Risks that changes in technological opportunities will reduce the value of the firm's existing systems for producing and delivering financial services

FIGURE 1

Components of Portfolio Risk for a Deposit Institution industry. Competition by insured institutions for subsidized borrowing and lending opportunities is so intense that deposit-insurance subsidies are ultimately shifted through to borrowers and suppliers of institutional funds. In competitive markets, subsidies are inevitably captured by owners of the scarce resources engaged in that enterprise. In the 1970s, profits made by institutions that first exploited such unregulated risks as maturity mismatching and sovereign lending were bid down by competition from follower institutions that were eager to participate in attractive opportunities. Ultimately, this competition transferred the subsidy to mortgage and foreign-country borrowers. In 1983, competition for insured money-market accounts is in the process of transferring the insurance subsidy on maturity mismatching to depositors. This explains why interest rates on these accounts can remain persistently above yields on short-term Treasury securities and even on money-market funds.

More generally, deposit-insurance pricing subsidizes the interest-volatility risk that S&Ls take in making fixed-rate mortgage loans. Subsidization occurs because explicit deposit-insurance premiums are based on total deposits and Congress strongly approves of maturity intermediation when it is undertaken by S&Ls to support mortgage lending to households. Political pressure prevents the FSLIC from administratively imposing a fully countervailing implicit premium on S&Ls that borrow short to hold long-term fixed-rate mortgages. This leaves the price of risk-bearing earned in fixed-rate mortgage lending far above the price charged for laying this risk off on the FSLIC.

Basic price theory tells us that competition should shift much of this subsidy forward to mortgage borrowers and backward to holders of insured money-market accounts. This theory has two observable consequences. First, it explains why insured money-market accounts can pay better rates than Treasury securities of comparable maturity. Second, it predicts that interest rates on fixed-rate mortgages held for an insured institution's own account would be forced artificially lower than the free-market equilibrium yield on these instruments.

We have only to look at current activity in residential mortgage markets to see the perverse effects of the continuing FSLIC subsidy to interest-volatility risk. Although we have to wait for hard data to develop, the financial press reports that S&Ls are jumping back into fixed-rate mortgages with the fervor of a previously reformed alcoholic returning to booze. The interest-volatility risk in fixed-rate mortgages is subsidized by the FSLIC, whereas adjustable-rate mortgages shift that risk to the borrower and (if only because of the risk of negative amortization) impose a greater risk of default besides. To most borrowers, having to absorb risks which go largely unpriced in a fixed-rate-contract makes the interest rate on an adjustable mortgage seem too high. At the same time, S&Ls' unique opportunity to arbitrage the price of risk-bearing between deposit, mortgage, and insurance markets makes them resist opportunities for asset diversification in practice that their trade associations strongly favor in theory. To an individual S&L, diversifying away a risk that the FSLIC is unable to protect itself against reduces the aggregate value of the subsidy this S&L could otherwise extract for its customers from the FSLIC.

Both consumers and consumerists recognize that the differential yield between fixed-rate mortgages (FRMs) and adjustable-rate mortgages (ARMs) is too low to price the favorable prepayment options that an FRM confers on the borrower. They suspect lenders of unfairly using monopoly power to keep the ARM rate above its market value. But once the role of the deposit-insurance subsidy is understood, the FRM rate may be seen to be the artificial rate. The yield differential is too small because the FRM rate is too low, not because the ARM rate is too high.

4. A Six-Point Program for Re-Regulation

The subsidy to risk-taking has greatly increased the fragility of our financial system. To cut back voluntary risk-taking, it is necessary not only to reprice but also to redesign the existing system of deposit-insurance coverage. The FDIC and FSLIC must develop incentive-compatible insurance contracts and price them fairly. In a world in which deposit institutions are highly levered and interest rates are highly volatile, systematically mispricing deposit-insurance guarantees encourages deposit-institution managers to position their firms on the edge of financial disaster. Metaphorically, deposit-insurance authorities are paying deposit-institution managers to disco on the window ledges of financial skyscrapers all over the country. The task of reregulation is to coax the dancers back inside each building's walls before it becomes too late.

Currently, low-risk deposit institutions pay unreasonably high premiums for deposit insurance, while high-risk institutions receive insurance at what is a bargain rate. Contractual incentives must be established that would allow a low-risk institution to lower its premiums by communicating to the insurance agency what its own managers know about the institution's net exposure to nontraditional forms of risk. At the same time, it should be possible to confront institutions whose risk-taking is found to impose unacceptable risks on FDIC and FSLIC reserves with a combination of reduced coverages and increased fees sufficient to move them back from the brink.

Although it is logically necessary that reregulation take place, the question is whether the 1983 round of regulatory readjustments will be adequate. The purpose of reregulation should be seen as making the FDIC and FSLIC act more like private insurers, so that they better protect their and taxpayers' economic interests and make uninsured depositors and stockholders bear more of the risk inherent in deposit-institution operations. This reregulation must administratively expand opportunities for troubled individual institutions to experience runs and even to fail.

The reregulation needed must include some or all of six basic changes in federal deposit-insurance contracts. The reader might view these proposals as column headings in a Chinese menu of nutritious reregulation.

1. Full disclosure of adverse information: Movement toward re-instituting market-value accounting for deposit-institution loans and investments can be justified as a cost-effective scheme for raising the implicit premium on deposit insurance in a risk-sensitive way. The most attractive element of this approach is that it lets market forces act as the arbiter that conducts risk assessments and sets risk premiums. In a world where market-value losses are not papered over by book-value accounting, deposit-institution managers who pursue unregulated risks know that they face quicker and more extensive damage to their careers when and if these risks go awry.

   Investors in deposit institutions and coinsuring depositors (those that are less than fully insured) deserve best-efforts estimates of the risk exposure and changing market value of the assets and liabilities that deposit institutions book. The development of hand-held calculators has led to software by which anyone can carry out present-value calculations. Moreover, secondary markets, supplemented where necessary by insurer-arranged auctions of similar assets, can provide a touchstone by which to choose appropriate discount rates.

2. Recalibration of insurance coverages: The pattern of coverages must be altered to generate information on clients' own perceptions of the benefits from covering risk and of their willingness to pay for alternative forms of coverage. As a strategy for assembling information with which to improve the rating process, I would recommend:

   a. Lowering the basic coverage per account (say to $10,000), with future limits indexed for inflation to make it difficult to reintroduce the real value of this coverage into the political arena.

b. Differentially pricing successive layers of supplementary coverages (offered, say, in $10,000 slices) and adjusting these prices by means of market principles.

c. Introducing provisions for deductible and coinsurance elements into this supplementary coverage. These elements could include provisions imposing additional penalties on stockholders of a failed deposit institution, as was the practice in the days before federal deposit insurance existed.

3. Risk-rated explicit premiums: These are needed to relegate implicit premiums on recognized forms of risk-taking to a lesser role. Opponents of this change emphasize that setting explicit premiums is a difficult task. However difficult it may be, it is not impossible. Private insurance companies contemporarily price many exotic forms of risk including the dangers of divorce, cancer, tax audits, and space debris. What is impossible is permanently maintaining a system that insures risk borne by deposit institutions at a price that lies far below the return offered in capital markets for risk-bearing services.

   Because risk-sensitive pricing is a hard task and requires considerable adaptive efficiency, it seems dangerous to assign the function wholly to government officials. This leads to the fourth point in my program.

4. Meaningful opportunities for private competition in deposit insurance: To introduce competitive discipline, it is necessary to provide opportunities for private firms to issue or reinsure at least some layers of supplementary deposit-insurance coverage. Authorities must invite into the contract-design and contract-pricing process decisionmakers whose only stakes are economic -- parties whose jobs and firms can and will be wiped out if they issue contracts which fail to make it each client's own best interest to keep its risk exposure under prudent bounds.

5. *Expanded opportunities for deposit-insurance agencies to manage their risk exposure*: Deposit-insurance agencies need enhanced rights to take timely action to cancel insurance coverage or to foreclose on the bank's charter before an institution's net worth is exhausted. The point is to stop institutions that are insolvent de *facto* from being permitted to make *end-game plays* with FDIC and FSLIC (i.e., taxpayers') money. Strengthening these rights could occur in many ways, though the most likely approach is to consolidate federal deposit-institution regulatory functions in federal deposit-insurance agencies.

6. *Statutory constraints on authorities' ability to bail out insolvent deposit institutions and deposit-insurance companies*. Deposit insurers must make their implicit guarantees of uninsured liabilities less perfect. This requires politicians to tie themselves to the mast of economic discipline so that (in the manner of Ulysses) they can resist the siren call of short-sighted opportunities for individual bailouts. First, deposit-insurance agencies should leave the short-term responsibility for stabilizing the financial system wholly in the hands of the Federal Reserve, acting in its capacity as lender of last resort. Second, except perhaps in the event of a *bona fide* crisis (defined, say, by the condition that 10% of aggregate deposit-institution assets have been involved in failures within the last 12 months), even the Federal Reserve's capacity for bailing out *insolvent* institutions needs to be constrained.

Senator HEINZ. Thank you, Mr. Kane. Mr. Horvitz.

STATEMENT OF PAUL M. HORVITZ, PROFESSOR, COLLEGE OF BUSINESS ADMINISTRATION, UNIVERSITY OF HOUSTON, HOUSTON, TEX.

Mr. HORVITZ. Thank you, Mr. Chairman. I'd like to request that my prepared statement be entered in the record.

Senator HEINZ. Without objection, so ordered.

Mr. HORVITZ. My comments this morning will focus on the relationship between deregulation and Federal deposit insurance.

I agree with Professor Kane's diagnosis, though my prescriptions are different in several respects.

Deposit insurance has worked very well in the United States for 50 years. It has eliminated bank runs, generating confidence in depository institutions, and thereby enhancing stability in the monetary system, and it has done so at low cost and with very small losses. But the deposit insurance system has been protected over this time by an elaborate system of regulations designed to restrict risk-taking by the insured institutions.

The trend toward deregulation is eliminating that protection. As an example, the elimination of interest rate ceilings on deposits allows risk-prone institutions to obtain virtually unlimited amount of insured funds through the use of brokers and hence there are no limits on the amounts of money that insured institutions can put at risk.

If we are to proceed further toward deregulation—and I think we should—we must address this insurance connection.

The Garn-St Germain Act recognized the problem and called on the deposit insurance agencies to consider various means of dealing with this. The problem I think is best seen by noting that in a world without deposit insurance the market would restrain risk-taking by banks and thrift institutions. In order to attract deposits banks would compete on the basis of their financial soundness and conservativism much as money market funds must do today.

DEPOSITORS LOOK TO THE FDIC OR FSLIC FOR PROTECTION

With deposit insurance, however, depositors don't care about the soundness of their individual institution. They look to the FDIC or the FSLIC for protection. The FDIC and FSLIC reports on deposit insurance called for by the Garn-St Germain Act consider various market mimicking devices to inhibit risk-taking. These include risk-related premiums, private deposit insurance, generating more market discipline by putting uninsured depositors at risk.

The differences between the recommendations of the FDIC and the FSLIC relate to differences in the institutions they primarily insure. The FSLIC is more enthused about risk-related premiums than the FSLIC because the risk faced by savings and loans is primarily interest rate risk which is more easily measurable than the risks faced by commercial banks. The FDIC is more inclined to make use of market discipline through uninsured depositors because commercial banks have substantial uninsured deposits, whereas savings and loans do not.

Though the FSLIC report does consider reducing $100,000 deposit insurance coverage, something that was also proposed by Professor Kane and by Assistant Attorney General Baxter, but that the FSLIC report rejects, I think on the reasonable grounds that it's impractical with the operations of money brokers who are able to combine and split deposits among institutions and would also lead to a concentration of deposits in large institutions presumed to be immune from failing.

My prepared statement sets forth the reasons why I think that none of these market mimicking devices are worth pursuing. Risk-related premiums and private deposit insurance are not feasible. Putting uninsured depositors at risk is feasible in the sense that we could put them at risk, but I think the cost of that may be greater than the benefits. That may promote runs and instability in the system.

I do have one positive proposal to advance, an idea that was discussed in both the FDIC and the FSLIC reports, and was discussed in testimony before this committee by FDIC Chairman Isaac, though not formally endorsed by him. I believe that substantial market discipline can be generated if insured institutions are required to have outstanding some amount of subordinated capital notes. The advantages of subordinated debt, as compared to equity or uninsured deposits, as a means of generating market discipline is that, first of all, subordinated debtholders do not share in any profit that results from excessive risk taking, so they have every incentive to buy notes only of sound institutions. Second, subordinated debtholders cannot run when problems materialize and so they cannot contribute to instability.

The supervisory agencies have generally preferred equity to debt. My comments suggest that debt is better as a source of market discipline than equity. In case of failure, of course, subordinated capital provides just as much protection to the insurance agency as equity. Also, as distinct from traditional supervisory views, I would argue that short maturity for subordinated notes is best. That requires the institution to be frequently in the market to sell new issues; so it is constantly exposed to market discipline.

Finally, a capital requirement, in terms of debt, is less onerous on banks than equity and can be applied to mutual as well as to stock institutions on an equal basis.

NECESSARY ELEMENTS FOR A REGULATORY STRUCTURE

In summary, my conclusions are that market mimicking devices such as risk-related premiums, putting uninsured depositors at risk, or private deposit insurance, are not sufficient to maintain public confidence and restrain risk taking. What we should be striving to determine is the minimum amount of regulation that's consistent with a sound deposit insurance system. While I do not spell out in detail a regulatory structure that's both necessary and sufficient to meet our needs, I suggest there are three important elements, and I thus end up with fewer elements than Professor Kane needs.

First of all, a capital requirement. Unless insured institutions are operating with their own capital at risk, the insurance agency is at risk and, as I've indicated, I think subordinated debt may be more useful than equity as a part of a capital requirement.

Second, we need a monitoring system. The insurance agency must have the means of obtaining good information on the condition of insured institutions. This probably requires a continuation of the examination process combined with some form of current value or mark-to-market accounting.

Third, the power to close failing institutions. The insurance agency must have the power to close an insured institution when economic net worth is depleted. This power is crucial and it's an important reason why private deposit insurance is not feasible. We're not likely to delegate this power to private companies, and without it the risk to a private insurer would be too great. Under such circumstances, a private company would be willing to write deposit insurance only if it had the right to cancel at any time. Since that would leave depositors at risk, we couldn't allow that to be part of the contract.

In summary, deposit insurance is important and confidence in the system must be maintained. In my view, that cannot be done without some minimal amount of supervision and regulatory power. I do not claim that the present system is perfect, but when we start with a system that has worked well for 50 years, the burden of proof is on those who propose change. None of the proposals that I have seen to replace regulation substantially with market mimicking devices bear that burden. Thank you.

[The complete statement follows:]

Statement of
Paul M. Horvitz
Judge James A. Elkins Professor
of Banking and Finance

DEPOSIT INSURANCE AND THE NEED FOR REGULATION

Federal deposit insurance has been one of the few great success stories of government intervention in the marketplace. The American banking system was plagued by instability from its earliest days. The National Banking Act resulted in a sound currency system, but as payments became deposit based rather than bank note based, the instability continued. Many hoped that the establishment of the Federal Reserve System would contribute stability to the financial system. It did not, and perhaps could not in a system consisting of thousands of small banks.

The FDIC was created to deal with this instability by preventing destabilizing runs on banks. During the 1920s and early 1930s it was possible for a sound financial institution to suffer sudden withdrawal of depoisits in response to rumors or doubts about its financial condition. This could result from the failure of a nearby or related institution, coupled with an important asymmetry in the costs of participating in a run: without deposit insurance, it costs very little to withdraw funds from a bank on the basis of a rumor that turns out to be false; on the other hand, the cost of not to withdrawing funds quickly, if the bank truly is about to fail, are very large. Even if I know that my bank is sound, when a run develops my best bet is to get my funds out before the actions of other depositors bring down the bank. Given the costs involved, participating in a run is not irrational behavior.

Federal deposit insurance has worked. Runs do not take place anymore, even when institutions are known to have substantial financial problems. Thrift institutions have been able to continue operating in a stable manner despite general knowledge of their insolvency. Interestingly, this stability has carried over to uninsured depositors. Because most failures have been handled through mergers (or purchase and assumption transactions) that have protected all creditors, even uninsured depositors have been willing to leave their funds in banks known to have problems (though the losses suffered by uninsured depositors in Penn Square may weaken that confidence).

Despite this success in bringing about stability (or perhaps because of it), federal deposit insurance has brought some other problems with it. Depositors no longer care about the soundness of their bank, particularly as the amount of deposit insurance has been increased over the years. Banks can now raise funds at the riskless rate, and they face no market penalty for investing in risky assets or activities. Without deposit insurance the market would impose a discipline by increasing the cost of funds to institutions that take increased risk. Deposit insurance removes that discipline.

Deposit insurance actually provides an incentive for increased risk-taking. Since the insured bank does not pay increased deposit insurance premiums, or increased interest costs, if it adopts a risky posture, the bank gains the increased returns that may be associated with increased risk. On the other hand, if the risks turn out badly, and the institution fails, the costs are borne by the insurance agency.

While academic economists have long discussed this probem, it was more theoretical than real for the first thrity years or so of the life of the FDIC. Bankers were generally a conservative group of businessmen, who operated in a cautious manner despite this economic incentive to risk-taking. Also, as problems developed over time, the insurance system was protected by increased regulatory powers. Most important, though its importance was not fully recognized at the time, Regulation Q interest rate ceilings represented a substantial protection to the insurance system. Interest rate ceilings limited the ability of risky institutions to attract funds, they were generally limited to what they could obtain locally. It is interesting to note that interest rate ceilings, though on the books since

1933, first became binding in the mid-1960s--the time that banks showed increasing proclivity to take risks.

The end of interest rate ceilings means increased risk for the deposit insurance systems. This is not because any significant number of depository institutions will be irresponsible in setting their rates (the traditional argument in favor of interest rate ceilings as a safety device). Rather, the end of interest rate ceilings means that an institution that is inclined to take greater than normal risks can obtain all the funds it wants by simply paying a modest premium over going market rates, perhaps by use of brokers. A savings and loan association in Chicago literally doubled its size in the week before it was closed.

Our traditional approach to a problem of increased risk in financial institutions would be to increase regulatory restrictions on their operations. But now the trend is clearly toward *de*regulation. It was not a coincidence that the Garn-St. Germain Act, a major step in the deregulation process, included a provision that called on the federal deposit insurance agencies to prepare analyses of the deposit insurance system and to consider changes to meet the increased risks they face with deregulation. The agencies submitted their reports about a month ago. They exhibit a general agreement as to the nature of the problem they face, and both the FDIC and the FSLIC recommend market-mimicking approaches to replace the market discipline that is lost with deposit insurance itself. It is my intent this morning to describe the sources of increased risk to the insurance agencies and to discuss the recommendations included in the Reports called for by the Garn-St. Germain Act. Rather than keeping you in suspense, I will tell you now that my general conclusion is that I do not believe that the recommended market-mimicking devices (such as risk-related insurance premiums or private deposit insurance) are appropriate to the problem, and that we must continue to rely on some amount of direct regulation and supervision of insured depository institutions.

There are several reasons to believe that the risks the deposit insurance system will face in the future will be greater than those of the past. Sources of increased risk include:

1. Banks are subject to greater interest rate risk now than in the past. Interest rates are more volatile, and it appears that this volatility will continue. Banks can take actions to minimize these risks, but such actions have costs or reduce profit margins. Some banks will be tempted to take greater interest rate risk, and some will incur losses.

2. Banks have assumed greater credit risks in their lending activities. The unsatisfactory performance of the economy over the last several years has resulted in increased amounts of nonperforming loans and loan losses. There are very substantial risks in the international loan portfolio of many large banks. The one very favorable economic development of the last year or so has been the substantial reduction in the rate of inflation. Inflation has operated in the past to bail banks out of some earlier mistakes, particularly in the real estate lending, and ironically, a reduction in inflation may tend to increase bank loan losses.

3. The virtual elimination of interest rate ceilings on deposits is beneficial to the economy as a whole, but it will increase bank costs and risks. Elimination of rate ceilings allows aggressive institutions to attract virtually unlimited amounts of insured funds through brokers. Further, investment bankers have been innovative in finding ways to link deposit insurance to other types of financing activity, such as mortgage revenue bonds

and industrial development bonds. All these developments pose increased risk to the deposit insurance system.

4. Most thrift institutions (and some commercial banks) are now operating with lower capital ratios than in the past. For many thrifts net worth is essentially zero (or less). This provides an incentive to increased risk-taking by these institutions. For an institution with negligible equity capital, any gains that result from excessive risk benefit the institution and its owners, while losses that result in failure are borne entirely by the insurance agency.

Economists have long argued that the tendency of deposit insurance to remove market discipline should be prevented by pricing deposit insurance so that risky institutions pay higher premiums than conservative ones. The analogy is frequently made with other forms of insurance--life insurance companies charge higher premiums to older people, auto insurers charge more to young men or those with poor driving records, and fire insurance companies charge more for buildings built of wood than of brick. FDIC and FSLIC officials have traditionally opposed risk-related premiums on grounds that they are impossible to implement--there is no actuarial basis for measuring the risk of bank failure. But in their Reports to Congress, both the FDIC and FSLIC recommend some form of risk-related premiums. This convergence of views among the academics and the policymakers is a rare event which would normally be praiseworthy, but in this case I am skeptical.

There are several reasons why I disagree with the call for risk-related insurance premiums. Deposit insurance is different from other forms of insurance with respect to risks and the costs to the insurance system. The losses of the deposit insurance system are not closely related to the riskiness of insured institutions. Losses of the insurance system are more a function of the timing of the closing of a failed bank. Most bank failures do not occur instantaneously, but rather result from losses over time. If the FDIC is able to monitor a bank's condition, and closes it when capital gets to zero (or slightly before), the FDIC suffers no loss--regardless of how risky the bank was. The life insurance company, in contrast, cannot cancel the policy when the insured is on his death bed.

The importance of this point is illustrated by the fact that the FDIC has lost very little over its fifty year history except when insolvency was undetected for a long time (as in such cases of fraud as U.S. National Bank of San Diego) or when the FDIC allows insolvent institutions to operate for a long time (as in the case of mutual savings bank failures). The Franklin National Bank case is instructive here. That was the largest commercial bank failure in history, but because that bank was closed when it became insolvent, FDIC losses in Franklin are close to zero. These considerations suggest that risk-related premiums would be inequitable or impossible to implement. If fraud makes it impossible to detect that a bank has become insolvent, that same fraud would prevent an accurate assessment of risk for premium-setting purposes.

The losses suffered by FDIC and FSLIC in recent thrift institution failures have resulted from a conscious decision to allow institutions to continue in operation even though their net worth, on a fair market value basis, was exhausted. If those institutions had been merged or sold or liquidated when they first became insolvent (perhaps as early as 1966), the losses of the insurance agencies would have been small. The decision to allow those institutions to continue in operation was based on public policy grounds, and may have been a correct decision in view of possible disruption to the mortgage market that might have resulted. But even if the decision was a correct one, it is impossible to relate a decision by the insurance agencies to risk loss from continued operation of insolvent institutions, to an actuarial assessment of risk-related insurance premiums.

Because of these considerations, I believe that the case for risk-related premiums is flawed on theoretical grounds. But even if risk-related premiums are desirable in principle, such a system would be impractical. If risk-related premiums are to serve their purpose of inhibiting risk-taking, they must be assessed on the basis of the risk itself, not on the outcome of risky decisions. That is, if higher premiums are not assessed until after the risky assets result in losses, then the premium structure has not accomplished its purpose. Punishment of management that has taken risks and lost may give us a feeling of satisfaction, but that is about all. If that bank is charged higher premiums in its weakened position, that may increase its chances of failing (and if it does, whatever increased premiums have been extracted from the bank will end up being replaced by the FDIC).

It is possible that penalties imposed on institutions that take risks and lose may discourage other banks from taking risks, but there are already reasons why managements seek to avoid failure. If increased punishment after the fact is warranted, there are other solutions that would be administratively simpler than risk-related premiums (perhaps tarring and feathering of those responsible for a failure).

The key difficulty with risk-related premiums is that we are not likely to be able to measure or even identify risks a priori, i.e., before they result in losses. If we were designing a risk-related premium system five years ago, would we have recognized loans to Mexico as particularly risky assets? Or loans secured by drilling rigs? Or even loans purchased from an experienced and active originator of energy loans? More important, ten years ago would we have recognized asset-liability maturity mismatches as a significant measure of risk for commercial banks? Bank management textbooks written as recently as the mid-1970s made no reference to interest rate risk.

Once again, if the riskiness of certain activities is only recognized after losses result, then the risk-related premium structure does not inhibit risk-taking. If higher premiums were assessed on Mexican loans today, no such lending would be inhibited (because no new loans are being made). If higher premiums were assessed on Seafirst or Continental after Penn Square failed, that could not lead them or others to be more cautious about buying Penn Square-originated loans today.

There is one type of risk which may be measurable enough for risk-related premiums to work. That is interest rate risk, which is particularly significant for thrift institutions. While it is very difficult to measure the credit risk in a portfolio, it is feasible, at least in principle, to measure interest rate risk. It is relatively easy to calculate asset and liability maturity mismatches, or gaps. While this is not the theoretically most precise measure of interest rate risk, it would probably suffice as a basis for differentiating among institutions on the basis of interest rate risk exposure. The FSLIC has indicated its desire to set insurance premiums in relation to some measure of interest rate risk. The FDIC has been less interested in this approach, primarily because interest rate risk is a less significant problem for commercial banks than for thrifts.

Deposit insurance in the U.S. has always attempted to maintain some degree of market discipline by limiting the extent of deposit insurance coverage, so that there are some uninsured depositors with an incentive to choose among institutions on the basis of soundness and conservatism. (This is not really the case for S&Ls, which have virtually no uninsured deposits--

but that fact itself may be an illustration of the workings of market discipline). Market discipline does not seem to work with respect to commercial banks because most large depositors simply ignore the risk that their bank will fail, confident in the knowledge that the FDIC usually handles a bank failure by arranging a merger that provides full protection for all creditors. Penn Square was a notable exception, but the FDIC went back to its usual procedures in the failure of United American Bank of Knoxville.

The FDIC report recognizes the advantages to the general public and to the FDIC of the P&A route, and proposes that market discipline be introduced into the P&A process by requiring that uninsured creditors share the loss with the FDIC even when a P&A is arranged. The problem with this is that although depositors would be at risk, as long as they are confident that they can move deposits before failure, they are unlikely to make distinctions among banks on the basis of slight differences in the probability of failure. That is, a customer can choose a bank at random and face roughly one chance in a thousand that the bank will fail during the year. It is just not reasonable to believe that he will expend great effort to select a bank in order to reduce that risk to, say, one in 10,000. Moreover, changes in disclosure policy that will be necessary to enhance market discipline will tend to increase the ability of depositors to move funds if serious trouble occurs.

In order for market discipline to be effective, potential depositors must have adequate information on which to base valid distinctions among institutions on the basis of their risk. Despite substantial improvement in the quantity and quality of information on bank operations that has been made publicly available in recent years, such information is not adequate to assess risk. Some of the needed additional disclosure is already scheduled, but more information on the quality and status of bank assets will be necessary. In particular, mark-to-market accounting will be necessary. This will be a burden on small banks which now are exempted from some disclosure requirements and who will find market value accounting a costly change. In fact, if the FDIC expects the market to make judgments as to the soundness of banks, it will be hard to justify keeping even examination report data confidential. Yet the availability of improved information will make it easier for a depositor at risk to move his funds before a failure occurs.

Further, arranging a P&A takes a fair amount of time. Now that the FDIC can consider interstate mergers, the time needed may be even greater than in the past. It is not realistic to believe that all such negotiations can be conducted in perfect secrecy. It is more likely that depositors will at least hear rumors about a possible bank failure, and will have the opportunity to move their deposits.

Even more extreme examples can be found in the FDIC's use of its authority to provide direct assistance to failing banks to keep them in operation. In such cases as those involving First Pennsylvania and Bank of the Commonwealth, the FDIC determined that without assistance the banks would fail, and that the continued operation of those banks was essential to their community. Those banks continue in operation. Depositors would not be likely to maintain funds in banks publicly identified by the FDIC as in danger of failing, if they felt they would suffer loss if the assistance turned out to be inadequate. This suggests that a move toward greater reliance on market discipline may rule out future use of this assistance approach.

These considerations raise the basic conflict posed by an attempt to harness market discipline into a useful role in reducing risk in the banking system. It is important to be explicit about this conflict, because it is often glossed over in discussions of the issue. The goal of an enhanced role for market discipline is reduced risk for the banking system that would presumably result from banks competing for uninsured depositors on the basis of financial soundness and conservatism. That is fine as long as all institutions are operated in a conservative manner and financial results are satisfactory. But some banks will sometimes be perceived as having significant problems. That may result from management mistake, poor economic conditions, bad luck on credit decisions, or even from a mistaken perception due to an unfounded rumor. In such cases an increased reliance on market discipline, in an environment in which uninsured depositors are at risk, will lead to instability.

As noted earlier, the original objective of FDIC was the prevention of instability in the financial system, specifically runs on banks. The success of the FDIC in achieving that objective may be undermined by policies that reduce the confidence large depositors feel in the safety of their funds in insured banks. In my view the risk of increasing instability in the financial system greatly outweighs any potential (theoretical) benefit from increased market discipline. We know the costs of bank runs--we have had them. We know the benefits of increased market discipline are limited, since with the existing lack of such discipline FDIC losses have been small.

The above consideration argues that even if market discipline could be made effective, it would be undesirable. But I also doubt that market discipline can become effective in the sense that depositors will be able to distinguish among banks on the basis of their safety or conservatism. The banking supervisory agencies have more information available to them on the condition of banks than private-sector depositors will ever have. Despite the availability of information, and the opportunity not available to others to obtain additional information through the examination process, the agencies have not been successful internally in "predicting" or identifying those banks that are most likely to fail. The supervisory agencies have generally rejected the concept of risk-related insurance premiums because of the difficulty of measuring risk. But that is the task that is set before depositors in choosing banks in a system in which they are at risk in case of failure.

The danger I see is that market discipline is likely to work only after the fact--that is, after some problem materializes that supervisors and depositors recognize, and when it is too late to deter the action or decision that led to the problem. Market discipline, like risk-related premiums, can be useful only if it serves as a deterrent, and not as punishment. While punishment of one bank may serve as a deterrent to another bank, that is not useful if the event that leads to market punishment is a result of bad luck or economic developments beyond the control of the bank.

The conclusion I draw from this analysis is that we cannot maintain federal deposit insurance and move to complete deregulation. Market mimicking devices, such as risk-related prmeiums, uninsured depositors at risk, or private deposit insurance, are not sufficient to maintain public confidence and restrain risk-taking. What we should be striving to determine what is the minimum amount of regulation that is consistent with a sound deposit insurance system. While I cannot spell out in detail today a regulatory structure that is both necessary and sufficient to meet our needs, I suggest that there are three important elements.

1. A capital requirement. Unless insured institutions are operating with their own cpaital at risk, the insurance agency is at risk. For reasons I have set out elsewhere, subordinated debt may be more useful than equity (briefly, buyers of subordinated debt have a strong incentive to select issues

on the basis of risk, since they cannot withdraw their funds at the first sign of trouble, like a depositor--thus, market discipline plays a role in the sale of subordinated debt).

2. A monitoring system. The insurance agency must have a means of obtaining good information on the condition of insured institutions. This probably requires a continuation of the examination process, combined with some form of current value or mark-to-market accounting.

3. The power to close failing institutions. The insurance agency must have the authority to close an insured institution when its economic net worth is depleted. This power is crucial, and this is an important reason why private deposit insurance is not feasible. We are not likely to delegate this power to private companies, and without it, the risks to a private insurer would be too great. In fact, under such circumstances, a private company would be willing to write deposit insurance only if it had the right to cancel at any time. Since that would leave depositors at risk, we could not allow that to be part of the contract.

In summary, deposit insurance is important and confidence in the system must be maintained. In my view, that cannot be done without some minimal amount of supervision and regulatory powers. I do not claim that the present system is perfect, but when we start with a system that has worked well for 50 years, the burden of proof is on those who propose changes. None of the proposals I have seen to replace regulation substantially with market-mimicking devices can bear that burden.

Senator HEINZ. Thank you very much, Dr. Horvitz.

Well, gentlemen, you've really covered the waterfront as well as the skyscrapers, Dr. Kane, quite magnificently and elaborately, and because you have covered a very broad swathe, I would like to try and bring together your testimony and focus on a couple of specific issues in which the committee has been quite interested.

EXPANSION TO OTHER FINANCIAL SERVICES

That is, the basic question on where you would come out on the advisability of allowing traditional depository institutions to expand their activities to other financial services. Some of you have touched on this but could I ask each of you just briefly to discuss the benefits and risks of expanding the financial activities that are permissible for depository institutions in the financial area and your views if they are different on nonfinancial area, other lines of commerce which are not like the financial areas, real estate brokerage, insurance brokerage, securities activities. Dr. Leveson.

Mr. LEVESON. I would allow virtually unlimited expansion of sales-and-service-type functions for both banks and thrift institutions. I would allow very widespread expansion of banking powers in the underwriting area with some limitations of the kind that I noted.

Senator HEINZ. You would have restricted the amounts?

Mr. LEVESON. I would restrict the amounts, percent of an issue, percent of a company's assets which it could own, percent of the bank's assets which could go into equities or conceivably the types of financing which it could participate in, but I would allow very broad discretion up to substantial limits and allow institutions to get together with other institutions to take on much larger financings.

Senator HEINZ. And you would keep the same kind of insurance system as we have today, in contrast with Mr. Kane and Dr. Horvitz who have rather different but quite significant suggestions?

Mr. LEVESON. As a matter of public confidence, I would keep the basic insurance system the same with an integration of the insurance for thrifts and commercial banks, allowing private insurance to develop for the rest of the financial system and then seeing to what extent those principles could be extended at a later time. I would change the pricing of insurance. I think to some degree that is feasible.

I would allow thrifts to be owned by nonfinancial institutions subject to a limitation on the extent of their corporate lending and without any essentially investment banking powers, but still with an ability to get into direct sales of securities and insurance; but I would not at this time allow banks to be owned or securities firms to be owned by nonfinancial institutions.

Senator HEINZ. You would allow banks to own investment banking firms?

Mr. LEVESON. I would allow banks to own investment banking firms. I would allow investment banking firms to own banks and put all of that into appropriate holding company structure with border sales and service functions outside the holding company structure which don't need the same regulation.

Senator HEINZ. Would you permit direct investments by banks in nonfinancial areas, you know, picture a bank-owned Proctor & Gamble?

Mr. LEVESON. I would allow that to occur quite broadly with limits on the proportion of a company that a bank could own and a proportion of its assets that could be in the securities of any one company, but I would encourage the type of practice I think that relationships between banks, and commercial and industrial firms will develop in ways that allow us to get more back into long-term financings. That is, as we look at the ways in which we've moved too heavily toward short-term financing as a result of inflation, there aren't that many options for moving back. One is asset-based loans which the banks already are in. Another is a formal indexing type of arrangement. Third is greater use of equity. And a fourth approach for long-term financing is to allow more of the development of relationships between banks and nonfinancial firms that will provide the information and even to some degree the guidance between sectors that allows us to have continuing doses of financing so we can get into 20- and 30-year projects where the working relationships give people enough assurances on both sides that the other party will go ahead. I think we've got to find ways to force that without being totally on the side of avoiding conflicts of interest because there's potential for a lot more improvement in risk-taking and innovation.

Senator HEINZ. When you say that you would set certain limits on the amount of extracurricular financial activities that were engaged in, it seems to me that you're accepting the notion that there still needs to be a regulatory structure based on safety and soundness.

Mr. LEVESON. Absolutely.

Senator HEINZ. If our present regulatory structure attempts—albeit it has been somewhat shaken and pierced here and there—to proscribe areas of activities by financial institutions outside a certain box or sphere, you seek to enlarge this space?

Mr. LEVESON. Yes.

Senator HEINZ. But what is your criteria for the amount of the enlargement that you would permit?

Mr. LEVESON. The criteria is to keep some limitations on the underwriting function and the securities ownership function. I would tend to allow relatively extensive activities in even these areas provided that we're able to keep the proportion of an issue that a bank is involved relatively modest.

RISK-POOLING

I think the key here is risk-pooling. If a bank is involved in underwriting and it's taking equity positions but it doesn't have a broad share of its assets in a single issue or it doesn't own such a large part of a company that we have to worry about the stakes being too intimately tied together, the system can work. That is, if we limit the size of the company, the issue that an individual bank can take, and force new consortia to develop that can spread the risks among institutions, then the banks can diversify and still have very heavy involvement in corporate finance in ways that will encourage the kind of risk-taking we want for the economy. So let the banks do a lot in the way of innovative corporate finance, but let them have limits that are low enough on individual issues so they are forced to spread the risks with other banks and spread their own risks among many different activities.

Senator HEINZ. If someone says, "Well, that's like getting them a little bit pregnant," how would you answer that?

Mr. LEVESON. For an extremely complicated economic environment which is likely I believe to remain relatively inflationary and require complicated adaptations indefinitely, we need a practical accommodation between multiple objectives. We're always going to be a little bit uneasy, but the alternative of saying nobody can do anything is the kind of stagflation that we've been living with.

Senator HEINZ. I guess that was an answer to the question.

Mr. LEVESON. I'm saying that the appropriate market adapatation is one that requires balancing goals that means that we're a little bit pregnant in several areas, and that can be the most efficient solution.

Senator HEINZ. Dr. Kaufman, what would you let financial institutions, banks in particular, do with respect to financial activities and nonfinancial activities?

Mr. KAUFMAN. Well, I'm not quite sure that what I would let them do is important, given the rapid changes in the marketplace and technology that permit them to evade and circumvent almost all regulations that we impose.

I do have certain problems or certain conflicts in my own thinking. On the one hand, being a free market advocate, I do not see any efficiency reason for not allowing them to engage in any type of activity that they wish to engage in. On the other hand, I have qualms that deal with the two points I raised in my statement—the conflict of interest with a particular focus on the conflicts between an underwriter on the one hand and the investor using other people's money on the other, and the concentration of power which is true both within the financial services industry and when you permit a combination of financial services and commerce. So I'm not quite sure at the moment what I would permit a bank to engage in. I suspect it would be broader than what they can do now. I suspect that unless Congress acts rather quickly it will be too late to prevent them from engaging in any type of activity that they wish to.

Senator HEINZ. While you're ambivalent as to exactly how far you would like to see them go with respect to the financial areas, insurance, securities, that is, what about nonfinancial areas, direct investments, if you will? Are you similarly ambivalent there?

REQUEST WIDE-SCALE STUDY OF SEPARATION BETWEEN BANKING AND COMMERCE

Mr. KAUFMAN. I am because I do not know what the consequences are. Our evidence are stories that we hear about what happens when we combine financial and nonfinancial are based on what happened in Germany and Japan and possibly what happened in this country in the 1920's. Yet we don't have a firm feel and we haven't studied, not only not carefully but, as far as I know, not at all what the consequences of these kinds of combinations are. I would urge Congress and this committee in particular to call for a brief but wide-scale study of what actually happens. What happened in other countries and what are the possibilities of happening in this country if we permit this kind of combination between financial activities and commerce that we talk about.

Senator HEINZ. Governor Wallich of the Federal Reserve Board has said on a number of occasions before Congress that there is a penalty that you pay by segregating banking from commerce, Glass-Steagall, and that that penalty is in effect certain inefficiencies that show up as less economic growth. Presumably, there are certain benefits in the form of a more stable banking system, presumably a more stable banking system leads to more rational consumer behavior, that is more saving, a higher saving rate.

Is it possible to do a cost-benefit analysis of as significant an issue as the separation between banking and commerce?

Mr. KAUFMAN. I would definitely think so and I would hope that it would not be very difficult to do so.

Senator HEINZ. Do you know anybody who's tried?

Mr. KAUFMAN. No, and that's why I said that I would like to encourage this committee to call for such a study because I think it's desparately needed.

Senator HEINZ. May I ask the other members of the panel, does anybody know anybody who's really attempted to quantify as long an existing an issue as shall we say Glass-Steagall?

Mr. KANE. A literature exists on the cost of prohibiting underwriting privileges for banks. This literature does try to quantify the cost of that restriction. Another stream of research quantifies the cost of deposit interest rate ceilings in the 1960's and 1970's. I think that if you look at individual topics, you could find such numerical estimates. But the numbers have never been pulled together into one study. One problem is that to write such a survey piece, one would have to be very well-informed about a wide range of specific areas. To be sufficiently informed enough about the array of regulations is very hard for one person.

Senator HEINZ. Well, let me ask you whether there is unanimity of opinion on Dr. Kaufman's point that such a study, first, could be done and, (b) that it would be valuable. Would you agree or disagree?

Mr. KANE. I think it could be done, remembering that in such studies the object is only to obtain about approximate measures of true opportunity costs. In a political environment, the accuracy of any measures will be attacked by people who find the numbers uncomfortable. So I'm not sure what the political value of this document would be, other than to focus the controversy on numbers.

Senator HEINZ. What do you think, Mr. Horvitz?

Mr. HORVITZ. I think it would be difficult to put a weight on some of the particular concerns Dr. Kaufman raised, the conflict of interest, for example. At the time that the Congress was considering the 1970 amendments to the Bank Holding Company Act, there was a lot of concern about the mingling of banking and nonbanking activities, and one of the specters that was held up in that discussion was the Japanese Zaibatsu, the giant Japanese firms that intermingle banking, finance, and manufacturing activities. The view in the late 1960's in the United States was that we certainly don't want our economy to become something like the Japanese economy.

Senator HEINZ. Or so we thought, before we realized how good they were.

Mr. Leveson.

Mr. LEVESON. I think that we need a thorough study of Glass-Steagall to look at all kinds of experiences, historical, comparative, quantitative to the extent possible, although not everything can be quantitated. I think what may be most valuable is thinking through the way in which the experience is applied in the future that might be quite different from the past or even the current situations in which they are being observed.

I should note that we just completed a first cut at the Universal Bank Development in Japan and Canada and Germany, United Kingdom and Switzerland, and you may be hearing about that from one of those giving testimony on the 27th.

MORATORIUM UNTIL A SOLUTION IS FOUND

Senator HEINZ. Returning to Dr. Kaufman, I want to ask Dr. Kane and Mr. Horvitz also the question I asked each of you earlier, but do you favor in effect a moratorium to give Congress time to come up with a more comprehensive solution? When I say moratorium, I mean on the de facto deregulation of the financial markets and industry in order to give Congress time to try and come up with a more rational approach?

Mr. KAUFMAN. I do with the provision that there be a specified time period. Even though I know that regulation Q was extended to the S&L's in 1966 as a temporary measure with a 1-year life and that 1-year life was extended and extended, I think that the issue is important enough and that it is very difficult to undo things that have been done, I do favor a moratorium.

Senator HEINZ. Now Mr. Kane—is it Dr. or Mr.?

Mr. KANE. If we need to be precise, it would be professor.

Senator HEINZ. Professor, Your Honor. You have proposed a rather extensive restructuring of what we now know as the Federal Deposit Insurance System. As I understand what you propose—and I would like to take the time to read your entire statement—you essentially argue for removing the direct regulation we impose on financial institutions that take deposits, the soundness part of the safety and soundness equation?

Mr. KANE. Not necessarily removing it, but relocating and reducing it—taking it out of the central role of the pricing process.

Senator HEINZ. Let me see if I've got it right here. And replacing it with a new system whereby various levels of activity are equated with levels of risks and these levels of activities and risks are then insured through what I gather would be something of a privatized system of Federal deposit insurance. Do I understand your concept correctly?

Mr. KANE. Partly privatized. Again, it's a matter of emphasis. I would keep much of the current system, in that the basic coverage would be governmental. But I would not extend the governmental coverage to such a large amount that every depositor feels fully insured, irrespective of the size of his account.

Senator HEINZ. Before I get to my central question or two, the notion is clearly intriguing, but I wonder if any market is capable of judging the kinds of risks that are involved here at this, if you will, second or third level of appreciation. What you're trying to do is get in a sense insurance companies that are partially responsible for insuring additional levels of risks to be the companies that fail in the system rather than have banks fail, which is not something we are terribly excited about having happen.

Mr. KANE. Well, we would have banks fail, too. One of the problems with deposit insurance is that we can't have banks not fail and not have everybody feel fully insured. So, if we want to control the risk in the system, we have to accept for some accidents for some firms. We have to allow some unpleasantness. It's like a sick person's having to take some bad-tasting medicine to start the process of getting well.

Senator HEINZ. I gather up to a 9-percent failure—judging from the last page of your statement, we should only worry if about 9 percent of our financial institutions fail.

Mr. KANE. Well, that isn't the purpose of that restriction. Ten percent is just a number used to represent the idea of a limit or switching point, at which it would be possible to permit a little more freedom with respect to bailing out troubled institutions. We've been routinely bailing out financial basket cases today. This has encouraged all firms to take even more risk. Especially once stockholders have no money of their own left in an institution, managers are encouraged to make terrifically risky plays to try to get some stockholder money back onto the balance sheet. We've seen that happen again and again in firms that have been allowed to operate after their true net worth was negative.

TESTING OUT A REGULAR SYSTEM

Senator HEINZ. I guess my question is, how can one test out such a regulatory system such as yours to determine its ability to withstand economic or financial stress before those stresses occur?

Mr. KANE. Well, I don't mean to promote it as an all-or-nothing system. My system differs from what Paul suggested only in having some added elements. Paul wants to subordinate creditors other than depositors; I want to see depositors subordinated, too. I want to see monitoring occur principally in requiring more accurate accounting. Market-value accounting would go a long way toward establishing better incentives for risk-taking. It would put the careers of people that take excessive risks very much on the line. That would help a lot. Focusing on S&L's, I think it is very important that these firms at least face explicit pricing. Paul suggested that we have explicit pricing for interest rate risks. We both fear that otherwise these institutions will walk back into the perilous situation they occupied before interest rates turned around in mid-1982.

The idea that we can't price risk precisely is quite different from the allegation that we can't price it at all. Insurance companies today price a number of exotic risks. Actuaries can price any risk.

Of course, they must impose charges for extra uncertainty and moral hazard when these exist. But a high price means that institutions and the depositors can decide whether they want to carry full coverage or not. Indeed, the credibility of the guarantees provided by an insurance company is one of the factors to assess in buying the insurance. My automobile insured in 1974 and 1975 by a then-troubled insurer named GEICO. I realized that if I had an accident during that interval, this company might not be able to pay my claim. Nevertheless, I continued to operate my car and pay premiums to GEICO. That's the kind of decision people make all the time.

Senator HEINZ. Is there anything that you would not let banks do?

Mr. KANE. Well, I would put the question another way. Is there anything we could keep them from doing? We must focus on feasibility. You may have children. If so, there are things you don't want them to do. What can you do to control them? What we see today is institutions doing things that the market impels them to do. Their responsibility to their stockholders lead managers to do things such as expanding their line of financial services into new areas, both in the scope of geographic coverage and in range of activities undertaken. They're doing this because of the technological changes mentioned this morning, principally in computers and communication. These changes are making it much cheaper to operate across long distances and to produce a given service as part of a wide line of products than as part of a narrow one. Some institutions are expanding an extra amount, though, because of the mispricing of insurance. That's the group the government needs to worry about. That's why it is important to undertake at least some of my list of reforms. I offered six reforms, but any portion of the six reforms will improve the system by curtailing some bad incentives. Any of these changes would be to the good, even if they're not all adopted.

Senator HEINZ. Could you answer your question which is, is there anything they shouldn't do?

Mr. KANE. What they shouldn't do is to pervert the deposit insurance system so that it underwrites all the risk in the country. This converts the deposit insurance agencies into risk bearers of last resort. This leads to very bad decisions about the kinds of risks that are financed.

ACTIVITIES BANKS SHOULD NOT ENGAGE IN

Senator HEINZ. I understand that. Is there any kind of activity that the banks should not be engaged in?

Mr. KANE. If the deposit insurance were appropriately priced, my answer would be no. This is not to say we don't have problems in the shape and enforceability of financial law. We can take laws with respect to business ethics and insider information laws as examples. These laws avoid fine distinctions by declaring that any profits made as a result of insider information—defined as broadly as possible—are subject to being taken away from those that make them: expropriated. There's a severe penalty if ever there was one. However, the Government seldom convicts anyone of having profit-ed by insider information. Similar problems in enforcing the prohibition of alcholic beverages encouraged the Nation to abandon that law.

Senator HEINZ. It's kind of like contemplating what penalties economists should suffer if they're wrong.

Mr. KANE. Some of us do suffer. To promote the demand for one's services, it is important not to be wrong, especially on important matters.

Senator HEINZ. Do you think that we should have a time limited moratorium——

Mr. KANE. I do not.

Senator HEINZ [continuing]. To give the Congress time to deal with this thoughtfully?

Mr. KANE. Congress acts much like my students. They start writing a paper a few days before it's due. If you adopt a moratorium, Congress will put the problem aside until about 2 or 3 days before the end of the moratorium. If they want to deal with the issue, they ought to get to work on it right now. They need to face the issue of the arbitrage of regulatory opportunities that is driving the system. To place a moratorium on some opportunities requires them to define boundaries. The moratorium will be circumvented, and it will be circumvented progressively more effectively if it's allowed to be renewed again and again. We could easily worsen whatever interests Congress wants to protect. In the time they think they are holding the fort, termites could be eating out the foundations of the defensive perimeter.

Senator HEINZ. I hope you've never assigned your students a term paper like you've assigned the Congress today.

Dr. Horvitz, is there anything that you would prohibit banks from doing?

Mr. HORVITZ. I don't think there's good reason to restrict banks necessarily from any activity. On the other hand, it seems to me there are very limited benefits from banks being engaged in general commerce. I think there's some synergy that may result from bank experience and expertise in being able to get into a broader range of financial activities, but it's hard for me to see any great benefits that would result from banks being in trade generally or in manufacturing.

So I think it is reasonable to continue our traditional separation of banking and commerce, not that I feel a strong need for it or reason for it. It has been a tradition that I don't see any great benefits from eliminating. I do see some benefits from banks getting into a broader range of financial activities where their experience and expertise may generate some benefits.

I think we're talking about something that may not be a very important issue; that is, the investment banking business, for example, is a very competitive business with relatively free entry. I don't see good reason for keeping banks out of that business, but I don't think that any great public benefits will result from commercial banks getting into the investment banking business. That business is already a pretty competitive business and while I wouldn't restrict banks from getting into it, I wouldn't expect that great benefits will result when they do.

RISKS IN INVESTMENT BANKING

Senator HEINZ. Is there any risks in banks getting into investment banking?

Mr. HORVITZ. There are some risks, though the disadvantages may be more in the conflict-of-interest area. The risks I think can be dealt with within the framework of what I see as an appropriate regulatory system. If banks are required to be operating with their own capital so they've got their own capital at risk, the amount of that capital is monitored and the regulatory agency and the insurance agency has the power to close that institution if its true net worth declines to zero, there are virtually no risks to the insurance system. That's why I think the analogy that's frequently made and that Professor Kane made, between deposit insurance and other forms of insurance is not a good analogy. It's misleading because I think deposit insurance is fundamentally different. The risks the deposit insurer takes are different than the risks of an institution failing. Franklin National Bank was our largest bank failure. It failed with no loss to the insurance system because it was closed when its net worth got to zero or about when it got to zero. The FDIC and the FSLIC really lose sizable amounts of money only when institutions are allowed to continue operating with negative net worth, and they have incentives, as Professor Kane indicated, to take greater and greater risks. If they are closed promptly, there's limited risk to the insurer.

Senator HEINZ. Well, there's a bank that comes to mind that's a fairly good-sized bank out on the west coast. It has over 100 percent of its capital in one relatively insolvent country, not the United States—just to clear that up—and the question is, should the regulators—how would the regulators deal with that? Here the bank has already lent 100 percent of its capital in one country. I don't understand how your regulatory system would work either to head that off or recognizing things as they are today. Should we close a bank I will not mention but remains the Bank of America?

Mr. HORVITZ. I think that is a very difficult question that is similar to the question faced by the FSLIC when a number of savings and loan associations became insolvent not because of bad loans but because of the decline in the market value of their assets and hence of their net worth. We should have an accounting system that reflects assets at their real value. As Professor Kane indicates, I think it is possible to set a market value on some of these assets if we want to do so. The very fact that we do so——

Senator HEINZ. Dr. Kaufman wonders if we want to do so.

Mr. HORVITZ. I think the institutions clearly at this point don't want to do so.

Senator HEINZ. Clearly.

Mr. HORVITZ. If we do so, and the fact that that is going to be reflected on the financial statements of institutions by itself would inhibit institutions I think from betting the bank on one such type of loan.

Senator HEINZ. Do you think we should enact a temporary moratorium to give Congress the time to hopefully deal intelligently with the issue, with the caveat that there's no guarantee that Congress is going to get an A on its term paper handed in on time or anything else, any more than there's any guarantee that Professor Kane always teaches every one of his students to think clearly?

Mr. HORVITZ. How long in advance did Professor Kane's statement get into the committee?

Senator HEINZ. From the standpoint of this member, not very far in advance.

Mr. HORVITZ. I generally tend to oppose a moratorium and my reaction would be that we get more pressure to reach a decision by letting the market develop than by imposing a moratorium. But I do recall—and my memory may be somewhat confused on this—one case in which I think a moratorium did work well was with respect to the moratorium on foreign acquisitions of banks that did give Congress time to consider the problem.

Senator HEINZ. I remember that.

Mr. HORVITZ. I thought you would. But that's one recollection that qualifies my general view that moratoriums are a bad idea.

Senator HEINZ. A question was suggested which is a good question which is, what is the danger in a moratorium to your mind? Where is the danger here?

Mr. HORVITZ. The principal danger I see in a moratorium is simply that it's a way of resolving a crisis at the moment and it may simply become easy to extend that again and again, and what appears to be a temporary moratorium may turn out to be a long-term prohibition.

Senator HEINZ. Is that necessarily bad, particularly if the prohibition is the right policy?

Mr. HORVITZ. But that sort of decides the question in advance, to say that a prohibition is the correct result. I think the move toward deregulation that we've had in recent years, deregulation of interest rate ceilings, came about because the market was pushing in a way that tended to wipe out the power of the regulation. I think the move toward interstate banking and expansion of institutions into one another's territory and activities is in general a desirable one. I'm not sure exactly how far we should go. I think we should go farther than we have, and a moratorium may permanently decide that—may stop that movement at the wrong place.

Senator HEINZ. I would just personally tend to agree with the notion that a permanent moratorium is just not the solution. It has been my experience that—and you correctly referred to it—the Congress does know, unlike Professor Kane's experience with his students—to know how to take advantage of a limited amount of time, and it's helpful to the Congress to be faced with a deadline. We do not always, Professor Kane, put things off until the last minute. Sometimes the expiration of a moratorium, like the prospect of hanging, concentrates one's mind wonderfully. And on this issue, judged by the four of you sitting down there, I would say we have at least a considerable amount of diversity of opinion represented at the table.

Let me ask Dr. Leveson—I did not ask you about your view on the moratorium, but I gather from your remarks you would not particularly favor one.

Mr. LEVESON. First let me point out that there's no private market in malpractice insurance for economists. In general, I would not favor it. It's very tempting to look for a moratorium to galvanize action in much the same way as the December 1979 Supreme Court decision on NOW accounts forced the Monetary Control Act to be passed within a short period of time, but the kinds of decisions that are inherent in the structural deregulation are quite different than the kinds that are inherent in rate deregulation. There is not the same sense of urgency in dealing with decisions that affect new activities that financial institutions might perform as there was in raising rates to prevent money outflows. So I'm somewhat skeptical that a moratorium would have the same kind of effect that the Supreme Court would have before. It's not under the same kind of pressure. My only hope would be that the introduction of a moratorium bill itself would have the same kind of impact that the Humphrey-Hawkins bill introduction had and would lead to actions by the Congress exactly opposite to the intent of the introduction of the bill. I would hope that it would become a vehicle for much more extensive deregulation rather than for a delay.

Senator HEINZ. So far, in terms of the moratorium, none of you have really addressed it on substantive grounds. You have addressed it essentially on procedural grounds, those of you who oppose the moratorium.

Mr. LEVESON. I think Professor Horvitz' objection is quite substantive.

Senator HEINZ. In what sense?

Mr. LEVESON. It's locked in over an extended period of time and that's a considerable risk.

Senator HEINZ. Personally, not to get into an argument about that, but I would consider that procedural. Certainly, if it became permanent, it would be substantive. I'm assuming that a temporary moratorium indeed is temporary as opposed to permanent. If you're going to have a permanent moratorium, he's absolutely right, but I've got to use the word temporary because that's what I've got in mind, not a permanent one.

Mr. KANE. I thought I raised a substantive point on the question of whether the moratorium could in fact be effective. Regulations could be written to prevent banks from being the vehicle, but could Congress prevent the combinations of financial products that they ultimately intend to control? Multiproduct firms are emerging in financial services to do things that banks have traditionally done. It would be very hard to have an effective moratorium for more than a very short time. The mere threat of a moratorium is causing more cross-industry takeovers to occur now than we would otherwise observe. The profit opportunities created by technological change are simply too great to blink away.

Mr. KAUFMAN. Let me just use Professor Kane's argument against him. Because of these changes, it's almost guaranteed that a moratorium is going to be temporary. These changes are going to occur that in time and probably quite quickly will make the moratorium quite ineffective, and then the Congress in its wisdom will repeal it.

Senator HEINZ. Professor Kane, would you like to rebut that?

Mr. KANE. Well, I find it hard to argue that if your goal is truly to stop something, you want to legislate against it ineffectively.

COMMUNITY DEPOSITS FOR LOANS TO BRAZIL

Senator HEINZ. One thing we haven't talked about is an issue that many of our members I'm sure would raise if they were here which is, as you talk about the notion of deregulating financial markets, it seems almost inevitable that the large get bigger and the small get smaller. Some of you have raised issues involving concentration of power, conflicts of interest. One of the concerns that is often expressed by members of the Independent Bankers Association is that "We are the community bank; we take deposits from the community; we lend them in the community. If Chase Manhattan or Citibank acquires our bank our deposits will be from the community but our loans will be to Brazil."

How do you deal with that kind of concern or issue? Who wants to take that one? Dr. Kaufman; and then I'll give Professor Kane a chance to rebut you.

Mr. KAUFMAN. I think there's a fallacy in that. We have not observed this in industries that are not regulated. As we move away from a regulated environment to a deregulated one, certainly some firms can get larger, but that does not necessarily mean that they're going to become more profitable. We noticed that in the airline industry. Some of the airlines that are in the greatest financial difficulties are the largest. Some that are doing financially the best are the newest and the smallest. This is true in banking. In the State of California, where I believe we have the largest concentration of banks of any State, we've had the largest entry of new banks. And this is true in Oregon also, which is a statewide banking State.

I think what you will find if you deregulate the financial sector there will be combinations that will make some firms even larger than they are today, but not all, and there will be large ones that go by the wayside. Some of the big ones are going to survive. Some of the firms will be medium size and some small. Look at the investment banking industry were some of the most profitable firms are small firms. If we go to the grocery industry, which is one we observe all the time, we see huge supermarkets and in their parking lots we see 7-11 stores. I do not think that history has told us in a free market that there's anything about size that will guarantee a success.

Senator HEINZ. What about the expressed fear that deposits will be taken in Williamsport, Pa., by an international financial institution and lent to some large, easy-to-identify customer that in theory is easier to keep track of rather than some small, perhaps prospering but nonetheless small customer like the Woolridge Company which probably does its banking in the Williamsport area?

Mr. KAUFMAN. Well let me make two comments on that.

Senator HEINZ. You can get a half a point more lending to Brazil or Mexico and you know the International Monetary Fund is going to rush in and you're going to have all your loans refinanced at a higher interest rate after the trouble starts, why isn't that a better place to invest than in the Wooldridge Company?

Mr. KAUFMAN. Well, let me make two comments on that. One is that the bank has a responsibility not only to the borrowers but also the savers and has an obligation to the people who put deposits in the bank to provide the highest return. Two, I think the experiences we talked about just a few minutes ago of some big banks lending in other countries indicates that they wish now they had it to do all over again and they may have placed those funds locally.

INTERNATIONAL DEPOSITORY INSURANCE

Senator **Heinz**. Well, one of the things suggested here is that we should rethink our international depository insurance scheme.

Mr. **Kaufman**. Definitely. I do not believe that we should have an international insurance scheme and I'm not sure it's the role of the Federal Reserve or the IMF to bail out the Chase Manhattan Bank or the other large banks in this country as long as their stockholders' wealth is above zero. I do not want to see losses especially to the insured depositors, and I see nothing gained——

Senator **Heinz**. I'm not sure I want to ask this question, but do you consider the IMF authorization that passed the Senate a bailout of the banks?

Mr. **Kaufman**. Partially.

Senator **Heinz**. I knew I shouldn't have asked. Professor Kane?

Mr. **Kane**. I agree that it is a bailout.

To predict what kind of firms prosper and whether local firms get financed, one has to take a broader view. Basically what is going to today is a reduction in the barriers to entry into individual deposit and other financial markets. The changing market structure results in large institutions operating across what used to be separate market niches. We tend to see the most successful multiproduct firms grow into very large firms, but with room remaining for small institutions to continue to operate profitably. In particular, in a small town in Pennsylvania, a local bank will have an advantage over outside firms in the credit function. It can better evaluate the creditworthiness of local borrowers. This lets it earn a little bit more or carry less risk than it would in the kind of foreign opportunity you cited. Depositors will respond to this, too. They are asked to chose between putting deposits in institutions that are lending to a good local firm or ones that are lending God knows where. Competetion should work that out very well.

Senator **Heinz**. Dr. Leveson.

Mr. **Leveson**. I think the development of the national and international money markets cuts both ways. It means that a sector that requires funds and is willing to pay modest amounts above the amount being paid by other sectors can have funds rush in from all over the country and indeed from all over the world, and that's the kind of development we see now with the tremendous interest in venture capital markets and the growth of new forms of bank lending to small business. The same thing can be true of communities as long as there genuinely is a return to be earned.

The problems come in essentially when we have differences in risks and in returns which are not being compensated for in the rate systems, but even then one can easily see that people will get tired of all chasing the same markets and crowding in and not getting very good returns and very quickly the lenders will spill over into developing specialized organizations for communities that have otherwise been unserved. It may not happen as quickly as some of the other developments and we may get a split between firms that try to be national and international and those that see that as an overcrowded market and try to really develop a knowledge of a wide range of communities across the country. But I see the larger organizations being able to provide very good community service as that market is allowed to evolve.

Senator HEINZ. Let me ask you one last question. I was thinking about how to ask it. I think I'm going to ask Dr. Horvitz because he had to sit there and listen to the first three witnesses and it's this: As you listened to the first three witnesses and taking your own testimony into account, were you able to perceive anything that the four of you agree upon that Congress or this committee should do?

Mr. HORVITZ. Yes.

Senator HEINZ. That you all agree upon, not that you think we should do, but that everybody thinks we should do.

Mr. HORVITZ. I think we tend among ourselves to focus more on differences, but I think there is a broad range of agreement even in the areas where there appears to be difference on details.

Senator HEINZ. What are the things that you think that you all agree upon that we should do?

AREAS OF AGREEMENT

Mr. HORVITZ. I think there's an agreement that we would prefer to move in the direction of less direct Government regulation and restriction on institutions, both in terms of activities and rates they can pay. We may have differences as to how far we move in the direction of removing restrictions, but I think we agree in moving from the point we are in the direction of less restriction on financial institutions.

Senator HEINZ. What does that mean? We don't write laws that say things like that. We write laws that say bank holding companies may form separate subsidiaries to engage in securities of x, y and z type.

Mr. HORVITZ. I think we would agree that banks should be allowed to conduct their operations regardless of State lines. I think there would be agreement among all of us in that regard.

Senator HEINZ. Is there anybody who disagrees with the outright repeal of the McFadden Act? The Chair will note that nobody moved a muscle, thereby signifying that everybody believes that State lines should henceforth cease to exist, at the table that is. All right. That's one.

Mr. HORVITZ. I think further we agree on elimination of restrictions on rates that can be paid on deposits, including the payment of interest on demand deposits or corporate demand deposits. I think there would be 100 percent agreement on that.

Senator HEINZ. Let me ask. Is that correct? The Chair will note that all limitations on the payment of just corporate?

Mr. HORVITZ. No, all restrictions on payment of interest on deposits.

Senator HEINZ. All right. What about earnings on reserves? Do you all believe that the Fed should pay earnings on all reserves?

Mr. **Horvitz**. I think that would be more controversial but I suspect among the four of us we would get agreement on payment of interest on reserves.

Senator **Heinz**. Is that correct?

Mr. **Kaufman**. I would say it's the second best solution. The better plan would be to eliminate reserve requirements as they are not necessary for conducting monetary policy. With the failure to do that, then I would favor the payment of interest on required reserves.

Mr. **Kane**. I support that.

Mr. **Leveson**. I'm on record going the other way on reserve requirements, but I favor paying interest.

Senator **Heinz**. You favor paying interest, but basically you favor one or the other as a group?

Mr. **Horvitz**. There's agreement on eliminating the burden of reserve requirements one way or another. Perhaps I should quit while I'm ahead.

Senator **Heinz**. No; we're not going to give you that opportunity. How about Federal preemption of State usury laws?

Mr. **Horvitz**. I think there would be agreement on elimination of virtually all usury laws.

Senator **Heinz**. That's not the question. We didn't enact the State usury laws. The States enacted the State usury laws. I'm asking the question about whether the heavy hand of the Federal Government should come down upon these helpless State legislatures that are unable to undo the terrible things that they have done in their own States presumably knowingly. This is the question of Federal preemption of State enacted mandated usury laws.

Mr. **Horvitz**. I would bet that you would get agreement in favor of Federal preemption among the four of us.

Mr. **Kane**. But the point here is that——

Senator **Heinz**. Don't make it complicated. Just give me a yes or a no.

Mr. **Kane**. Our economic expertise leads us to say, yes, we would like to see usury ceilings go. Whether we want to weigh this against a decision about States rights to do this is——

Senator **Heinz**. That's the question.

Mr. **Kane**. But if you want us to talk about this issue as economists, what can we say? We can be in favor of that, but it is merely a political opinion to say that we think it's so important to have the usury ceilings taken away that we would be willing to support a loss of freedom for the States.

Mr. **Kaufman**. I agree with Professor Kane and I also favor the invisible hand over the heavy hand.

Senator **Heinz**. You might find a lot of support for the invisible hand.

Mr. **Leveson**. I would make a political judgment that that is not the right battle to fight at this time. We could come back to it but the economic costs are not that great and competition among the States will keep the economic costs limited for a while. If we get a big surge in inflation and it looks like it's going to stay, then I would come back and say I'm in favor of it.

CONDUCTING INCREMENTAL FINANCIAL ACTIVITIES THROUGH SEPARATE SUBSIDIARIES

Senator Heinz. Do you all believe that banks should conduct their incremental financial activities through separate subsidiaries or should the banks be allowed to do them directly?

Mr. Horvitz. I don't think you would get agreement on that.

Senator Heinz. Let's find out where we get disagreement as well as agreement. What do you favor?

Mr. Horvitz. I would not restrict banks' new financial activities to doing it through a holding company. I think in some cases that may be harmless but in some cases that will add to the cost of doing business.

Senator Heinz. All right. So you see no need to have separate subsidiaries for new activities, which I gather means all these activities?

Mr. Horvitz. Insurance, investment banking, whatever.

Senator Heinz. All right.

Mr. Kane. I have much the same view. I don't think separate subsidiaries have much effect in the end. Ultimately, risks spread across the conglomerated or consolidated firm.

Senator Heinz. Dr. Kaufman.

Mr. Kaufman. I feel the same way and I might note that I have changed my mind in the last year as a result of a very persuasive argment by Prof. Robert Eisenbies of the University of North Carolina who has studied this issue in great detail and concluded that it doesn't make much difference whether it's a subsidiary or bank directly.

Mr. Leveson. The only function I can see absolutely needing separate subsidiaries is underwriting of stock and bond issues and commodity issues. Banks are establishing more and more corporate lending departments with powers to deal with the needs of the whole firms in creative ways rather than turning pieces of the needs over to a separate loan officer who doesn't look at the total, and that means an integrated operation. The other functions for the most part I don't even see the need to be in bank holding companies.

Senator Heinz. Now 3½ of you made an interesting statement which is this: you say that there isn't really much difference— three of you for certain— as to whether banks have separate subsidiaries, no matter how carefully you may craft those kinds of subsidiaries to be in theory independent; and I gather, Dr. Leveson only feels that there would be a need for such a separate subsidiary with respect to commodities or securities underwriting.

If these gentlemen feel it makes no difference, three out of four of you feel it makes no difference, let me ask you, Dr. Leveson, why you think there is in fact any difference in having a subsidiary?

Mr. Leveson. First of all, in terms of eliminating the kinds of abuses that are generally thought to have been dealt with by Glass-Steagall I would say is only partially helpful in the cross-lending into failing related ventures and so on. The experience with the REIT's suggests that you can have considerable problems even with a separate subsidiary, but I think there's some degree of moderating the risks. If insured deposites are the basis of monetary policy and the protection of the public trust, then there's an argument for having a subsidiary that allow activities that might be at times fairly speculative and capable of failing subject to limited liability and not carry over to insured costs. It's not primarily preventing conflict of interest.

Senator **Heinz**. Let me ask the other three members of our panel, do you feel that a separate subsidiary will in fact moderate risks?

Mr. **Kaufman**. No, I don't.

Mr. **Kane**. No I think downstream and upstream transfers of funds and risks can occur in so many ways that risk-sharing across subsidiaries can't feasibly be regulated.

Mr. **Horvitz**. I think it may be possible. That involves legal rather than economic issues and it may be possible to construct a separation that insulates the bank from affiliates. I think that is more a legal question of limiting liability and preventing of piercing the corporate veil and all. Maybe it can be dealt with.

Senator **Heinz**. Let me give you my own prejudice on this. My own prejudice is that I agree with Dr. Kaufman and Professor Kane, which is that if a subsidiary of a bank holding company and also of the bank fails, the ability of the bank holding company to raise additional equity is going to be hurt. If the bank at the same time is required to raise additional capital, it will be very difficult for that capital to be raised simply because of the way investors view the parent holding company.

Now I don't know what it was that convinced you, Dr. Kaufman, whether it was that kind of analysis or not, but does that kind of analysis seem at all persuasive to you?

Mr. **Horvitz**. Yes, but I think there may be some instances in which the failure of a subsidiary may occur without the affiliated bank necessarily failing. We've had just a few cases in which this has occurred. In general, we have not to insulated the bank from problems that develop elsewhere in the holding company family, but I'm not sure that it's impossible. That's all. I'm not saying that we can insulate it, but I'm not sure that we can't.

Senator **Heinz**. Dr. Kaufman, what was it that persuaded you to change your mind?

Mr. **Kaufman**. It was Professor Eisenbies's study.

Senator **Heinz**. But what was it in his study?

Mr. **Kaufman**. Items such as yours that the banks can find ways of getting around it. If you can downstream legally, you can't hold the subsidiary separate from the parent company. In the public image, it's the same. In the operation of the company, it is the same. That it's just a paper separation which does not hold in practice.

Senator **Heinz**. Presumably, a good example of that would be the Butcher banks in Tennessee where they were totally separate but had apparently very similar practices.

Mr. **Kane**. Well, one other point is that the economies of joint production lead to an implicit integration of subsidiaries whenever it's economic for them to be integrated. That makes it all the harder to effect a separation. As Paul said, it might be possible, but it seems to me it's so unlikely a prospect that I would not like to see Congress try to write that assignment.

Mr. **Leveson**. I'm impressed with the experience in the Baldwin United case even though it was under State insurance regulation really raises many of the same issues, and there the principal problem was that the firm exceeded the legal limits on lending between affiliates. Had appropriate lending limits been enforced, I think some of the problems certainly could have been avoided.

The practical issue is whether or not we choose to set lending limits between affiliates even if we can't completely enforce the kind of commitments that they've made, but that may be able to prevent some more extreme situations.

Senator **Heinz**. Now I just have one question that I know you may think I've asked before but it becomes an issue that raises its head with specificity and so although you may have covered it in a general way, forgive me for seeming redundant.

SHOULD BANKS OWN UNDERWRITING FIRMS OR UNDERWRITING FIRMS OWN BANKS

The question is, should banks own underwriting firms or should underwriting firms own banks?

Mr. **Horvitz**. I would not restrict them from doing so. I believe they should be allowed to either way. Certainly if it goes one way, it's got to go the other way.

Senator **Heinz**. Professor Kane.

Mr. **Kane**. I agree that ownership should go both ways. But at the same time we should collect information that would facilitate prosecution of unethical behavior. Intrafirm decisionmaking should be a very open process, so that potential victims can observe any lack of safeguards and see when chicanery was underway.

Senator **Heinz**. What does that mean in practice?

Mr. **Kane**. Perhaps to have auditors look at what was going on after the fact and catalog publicly every problem they saw.

Senator **Heinz**. We have this organization called the Securities and Exchange Commission that looks in on these things. Are you suggesting that the SEC should do something differently?

Mr. **Kane**. The SEC does not write rules governing disclosure of what goes on at banks, even when banks are involved in underwriting. It does regulate large and widely held bank holding companies, though.

Senator **Heinz**. Dr. Kaufman.

Mr. **Kaufman**. Yes, with 1½ proviso. The major proviso is the writing of appropriate rules to limit the conflicts of interest in self-dealing and some of this is in the administration's bill and other attempts at this which does have provisions, and two, reluctantly, I do not favor at this time equity, but probably over time. At the moment I prefer heavy equity underwriting.

Senator **Heinz**. You would favor debt underwriting, but not equity underwriting?

Mr. **Kaufman**. Yes.

Senator **Heinz**. You mean the banks should not be allowed to own firms that do equity underwriting; is that what you mean?

Mr. **Kaufman**. Right, or vice versa.

Senator **Heinz**. Could you elaborate on why you feel regulation to proscribe conflicts of interest would be sufficiently affected?

Mr. **Kaufman**. Well, I don't know whether it would be sufficiently effective. I think they could be written so there could be monitoring. There could be some enforcement and hopefully they would be effective. One never knows when one writes regulations whether they can be totally effective. I suspect from my knowledge of the industry especially what's happened since 1933 with disclosure that one can write regulations that will be reasonably effective.

Mr. **Leveson**. I would basically allow ownership both ways.

Senator **Heinz**. Now let me ask you a different kind of question. This is kind of a Chinese menu kind of question. If you grant the hypothesis that the principal difference between banks and S&L's and other kinds of financial institutions is the taking of retail deposits and the words safety and soundness standards are really designed to fundamentally protect those retail depositors—the former through insurance, the latter through oversight regulation—the kinds of commercial lending activities the bank can engage in, what would be the difficulties or disadvantages or flaws in basically having two kinds of banks? One would be banks that could operate under the present system where deposits are insured; soundness requirements are enforced much as they are now. The lines of business of the bank therefore would be constrained much as they are now. But if you wanted to be a different kind of bank you could but you would have to sacrifice in effect your Federal deposit insurance and presumably some kind of private insurance system or federally chartered insurance system, a kind of philosophical equivalent of FNMA might be established to deal with the insurance aspects of that kind of new two-tiered system; is that an absolutely off the wall, crazy kind of idea or is it a sound way to approach this issue?

Mr. **Horvitz**. To some extent we have that now but the institutions that want to operate without deposit insurance and operate without a bank charter can do pretty much what they want. The disadvantage of that scheme, it seems to me, is that it suggests a diminished role for insured deposits in the financial system and I think the deposit insurance has been valuable in providing stability to the system, confidence in the system. That would be weakened if a greater part of the assets of the depository institutions were outside the insurance scheme, with institutions that could do what they wanted or perhaps could afford to pay higher rates and lure funds away from the insured sector. I see that as a disadvantage.

Senator **Heinz**. What about requiring that there be deposit insurance of the nonbank bank, if you will, but that they basically generate their insurance from the private market? I see Dr. Kaufman shaking his head.

Mr. **Kaufman**. I think we get ourselves into another problem. I do not see that private insurance can deal with that problem. Consequently, we're going to have to worry about insuring the private insurance companies and will be just transferring the insurance from the banks to the insurance companies. That doesn't solve the problem.

Senator **Heinz**. Now Professor Kane you were basically arguing toward the system that did what Dr. Kaufman said we shouldn't do.

Mr. **Kane**. Well, my ideas are somewhat akin to your own. The question is what kind of insurance contract we want to write. The one that has been written in the past worked very well in times when we had relatively little interest-rate volatility. If you solve through the economics of valuing Federal guarantees in the presence of very volatile interest rates, serious underpricing results in times like ours. Deposit institutions have uninsured competitors—money-market funds—that before the Garn-St Germain Act were doing very well. In fact, people from the deposit institutions railed that not regulating money funds was unfair. But today the deposit insurance subsidy is allowing the deposit institutions to regain a great deal of business they had lost because of deposit rate ceilings. They're recapturing more business every week. In today's system, the size of the deposit insurance subsidy is critical to whether we can continue to operate with both insured and uninsured competitors for liquid savings. This question brings us back to the issue of how to price deposit insurance.

Senator **Heinz**. Dr. Kaufman.

Mr. **Kaufman**. I think the money market fund is not a good analogy. What makes deposits unique is that they're always at par value. The money market funds operate as if they are, but they don't have to be. Their liabilities are the value of the assets. Legally, they're not bankrupt by reducing the value of their liabilities. With the bank it is different. They always have to repay their deposits at par value and that makes insurance much more difficult.

Mr. **Kane**. But what the rational customer is concerned about is to what extent his funds are at risk. If an institution doesn't go broke, but the customer receives only 1 cent back per dollar of deposits, he would see very clearly that he had lost money. In that sense, money-market funds put their customers' principal at risk. That's what I'm saying. So I don't understand why it's important that the money-market funds themselves stay intact because they mark to market. In fact, I'd like banks to mark to market, also. That's the No. 1 component of my program of reforms.

Mr. **Horvitz**. That's another thing we could get agreement among the four of us on is for more disclosure of market values of assets and liabilities.

Senator **Heinz**. Let's take a minute on that. What is the barrier to more disclosure today?

Mr. **Horvitz**. I think we have moved very substantially in the direction of fuller disclosure over the years and now there is going to be substantial disclosure of information on problem loans and interest rate sensitivity of assets of banks, but I would go the one further step and require that loans and investments be carried on a fair market value basis. I think if one argues that's impossible, then we clearly can't go the further step of talking about risk-related insurance premiums. That becomes a necessary first step, to be able to have mortgages and other loans valued on the books of an institution at market value.

Senator **Heinz**. I can understand economists to a man coming out in favor of having the assets of the loans in effect of banks being valued at market. Well, maybe there's one——

Mr. LEVESON. I want to be a little bit different about this one, too. I think that sometimes the only way you get through a crisis is with mirrors and there's such a thing as going concern value.

Senator HEINZ. Also known as good will. But my question is, suddenly you have been made the chief executive officer of a large bank and what would be your reaction to those people up on Capitol Hill having just told you that you've got to value all of your loans at market? What would you say?

Mr. HORVITZ. If I were in that situation, I would say that's a very good idea and the time for it will come sometime in the future, but now is the wrong time to start that kind of system.

Senator HEINZ. Would that be your only reservation as a CEO?

Mr. HORVITZ. I think the majority of bankers and even thrift institution executives would agree in concept with the idea of market value accounting or at least market value reporting, but would argue that this is the wrong time to start it, that at sometime in the future when they've gotten rid of these old below market-yield assets, that would be the right time to start such a system.

Mr. KANE. Because the transition costs of moving to market-value accounting are high, the way to introduce it would be to schedule its adoption as of a fixed date in the future. At the same time, we should let any institution that wanted to adopt it earlier to do so. Provision of information would then become part of a firm's competitive strategy. Some institutions would find that they could advantageously go to market-value accounting.

Senator HEINZ. Would you do it for both assets and liabilities?

Mr. KANE. Sure.

Senator HEINZ. It would be interesting if we had had it 5 years ago to see how you would value deposits under regulation Q. Presumably you would write that off substantially.

Mr. HORVITZ. Well, the liabilities would be written down.

Mr. KANE. Yes; the rising interest rates would write down the value of the liability. To account for the effect on a net worth, we need only put a minus sign in front of it.

Mr. LEVESON. The only switch to stock companies before the big surge.

Mr. KAUFMAN. I think the assets were. The deposits just wouldn't be marked down. I completed a study recently, as did Paul Horvitz, for the Federal Savings & Loan Insurance Corp. I had the responsibility for the section that dealt with risk sensitive premiums and we had to get into this problem of market value. We met a number of times with leaders of the thrift institution industry and I think Paul's statement is very representative of their views. Yes, they would like it, but the time is not now because all the net worth would be negative. If you were the chief executive officer the last thing you would want to be operating is a firm with a negative net worth.

There's also one problem, especially with the S&L's. There's a lot of nonmarketable assets and it is difficult to market them at value in the market. It doesn't mean it's impossible, but systems have to be set up. I hope the regulatory agencies and, particularly the insurance agencies as the FDIC, will start working very quickly on gathering the information which would yield interest rate information which can be given to the institutions to value their nonmarketable assets at a market price.

Mr. **Kane**. I'd like to add one point. For their own internal decisionmaking, many institutions already value these securities at market. They do find ways of estimating market value. They simply prefer not to make these figures public. It's very hard for a firm to make reasonable decisions without having worked through what is the true gain and loss in its portfolio.

Mr. **Leveson**. One reason the dissensions between securities and other activities are so fuzzy now is because we've been living in an environment where fluctuation in bonds have been as great as fluctuations in stock prices so that firms initially insulated have to learn how to handle market risks in any event.

COMMENTS ON FDIC INSURANCE STUDY

Senator **Heinz**. One thing I think you're all aware of is that the Congress recently received the results of the FDIC insurance study and the proposals in there are, I gather, quite far reaching in terms of the restructuring. I understand Dr. Horvitz is quite familiar with many elements of that study. And practically speaking, it's probably going to take the Congress a little while to come to grips with all the information in that study, several months, many, many months. It will take us sometime to fashion a consensus assuming we can reach a consensus. The reason I stipulate that is that that suggests to me that that sounds like to me an argument that if we're going to do any of the kinds of things you gentlemen seem to agree upon, that we should do it in concert with the kinds of changes in insurance regulation that we will in the future reach agreement on.

That being the case, would you all agree that it would be a little hasty for us to try and deal with the financial deregulation question today and the insurance questions 6 months later? Would you all agree we should handle these together? Does anybody disagree?

Mr. **Kane**. Some issues are inseparable. That's the first thing one must establish: Which problems can be separated.

Senator **Heinz**. Are there some that can?

Mr. **Kane**. The prohibition of interstate banking is something that technology has already wiped out. This law is largely an inconvenience and it costs regulatory resources to administer it. I don't think we need to wait for deposit insurance reform to move on this front.

Senator **Heinz**. Any others?

Mr. **Kane**. Well, ceilings on deposit rates are also disappearing.

Senator **Heinz**. Interest on reserves, wouldn't be tied to it, or if some of you prefer the elimination of reserves?

Mr. **Kane**. The only caution I'd add about interest on reserves is that reserve requirements are a mild tax and a differential tax that to a small extent offsets the insurance subsidy. If you relax the prohibition of interest on reserves, it would create additional pressure on Congress to resolve the deposit insurance problem. It would step up the pressure for setting some deadlines for the deposit insurance reregulation process.

Mr. LEVESON. I think the reason we have been trying to tie things so together is because there are specific proposals which if adopted would tie them together but those may not be probabilities that we will accept. For example, if what we are trying to do is establish a framework that says you can only go interstate through a bank holding company, then we have to define the powers of a bank holding company in a new context. But if we agree that a wide range of activities can take place outside of the bank holding company structure, then we can eliminate consideration of geographic restrictions on those. I think there has to be some resolution of a basic structural framework even to allow the interstate decision to move ahead, but there are so many issues that we are likely to need several major bills in 3 or 4 years in order to sort it out. The question is when do we get started?

Senator HEINZ. Well, gentlemen, whenever you get intelligent people together, one of the things you get is disagreement. You have given us both agreement and disagreement. I've found that your testimony and your responses have been extremely helpful, most enlightening, quite challenging. I, on behalf of the committee, want to thank you for your time and for your energies in preparing and helping the committee and hopefully once we figure out exactly what it is that you all really think is in the best interest we'll follow through with legislation that will solve every single one of the problems that we have identified here today.

Mr. LEVESON. Mr. Chairman, if I may, we'd like to thank you for an extraordinarily and engaging discussion.

Senator HEINZ. Compliments will get you invited back.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

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CHANGING TECHNOLOGY AND FUTURE FINANCIAL ACTIVITY

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1. Introduction

The scientific community and suppliers of computers, telecommunications, and information system hardware and software say that there is an abundance of technology available for the production of new financial services and for reducing the costs of present services. Integrated circuits are predicted to grow from the present 64K and 256K capacities to over 1,000K by the end of the decade. These VLSIC's will provide not only great reductions in the cost of memory, but will as well offer increasingly complex and efficient microprocessing and switching. "Smart" terminal devices associated with two-way, interactive information networks are said to be in their infancy and susceptible to rapid development. Digital PABX and other local network switching and transmission facilities are now being deployed. Security and privacy remain as critical issues in systems development but new technologies are emerging on these fronts as well.

There is more here than greater functional capability. The new transmission methods promise both enhanced capabilities and lower costs. In addition to improved hardware and software for switching and computation, there are new techniques for network design and network management. Networks and sub-networks can be interconnected in horizontal and hierarchical arrangements, with specialized functions in some parts of a network and collections and rearrangements of these functions in others. In a general sense, technology appears to provide means for efficiently hooking any kind of information in any form to anything else, with broad processing, storage, retrieval and transmission alternatives through time and across large geographic areas. The use of technology for the provision of financial services will in large measure be shared and combined with its use in other telecommunications and data processing services.

A quick assessment - and probably a correct one - is that technology, narrowly defined, will not be an important impediment to the provision of new and lower cost financial services. Such services are, after all, increasingly nothing more than new means of moving numbers about on a growing array of balance sheets of individuals, non-financial businesses, financial institutions and governments. As seen by Dee W. Hock (1977), the "new world", will "unlock a value reservoir to which [transactors] have never had access ... [A transactor] from anywhere in the world [will be] in full possession of all his assets, whether credit, deposit, investment, or equity ... [and will be able] to exchange them for whatever [any other transactor wishes] to sell."

That such a world will quickly arise seems more than a fantasy. A good deal of it has been put in place, some before and some after Mr. Hock gazed into his crystal ball six years ago. An indication of the magnitude of growth in asset transacting appears in bank debits. In 1970, for example, the annual turnover rate for demand deposits of New York City banks was about 150. On average, each dollar in New York demand deposits was exchanged 150 times per year. By late 1981, that rate had reached more than 1200. New York demand deposits were turning over three times per day. This reflects nothing other than an acceleration in the rates at which various types of assets are being exchanged for one another. New markets have appeared, better information is available, transactions costs have fallen, the liquidity of many assets has increased and, of great importance, the increase in interest rates over that period put a premium on efficient asset management.

The technologists indicate that there is no end in sight for what they can do. Further, it appears that institutional impediments for using technology are becoming of less importance. The deposit institutions gained new operating freedoms in the Depository Institution Deregulation and Monetary Control Act of 1980 and still more in the Garn-St. Germaine Depository Institutions Act of 1982. The Glass-Steagall Act's prohibitions on mixing investment banking and the taking of deposits remain the letter of the law, but the number of ways to circumvent the Act grows almost daily. Similarly, the McFadden Act and Douglas Amendment constraints on interstate banking have become of considerably less relevance to imaginative financial entrepreneurs.

These developments raise important questions. Are we foreseeably to continue on the path of innovations in financial services? Will there be a rapid demise of the older and, particularly, the smaller financial institutions? Will consolidations and disproportionate internal growth result in the evolution of a few national and international financial supermarkets? Is the end in sight for the locally owned and the specialized financial institution?

These questions cannot be answered with certainty. There are reasons for believing, nonetheless, that the pace of innovation in financial services, while brisk, will be a good deal slower than that which appears to be technologically feasible. Additionally, there are reasons for believing that, while significant restructuring will occur, the few financial supermarkets that do arise will not cause the wholesale displacement of smaller institutions. In fact, the success of the supermarkets may depend on their effective use of smaller, local institutions.

One reason for holding that the rate of change will be moderate lies in the deregulation that has now transpired. A number of notable service innovations - money market funds, a variety of "sweep balance" accounts, NOW accounts and, to a degree, new markets for instruments such as commercial paper, Eurodollars and repos - arose primarily as vehicles to circumvent regulations. With Regulation Q largely gone and with explicit payment of interest on some types of transactions deposits, the impetus for the growth in such services has been abated.

Another reason for the moderation of change is related to technology. Major innovations typically rest not on a single, independent development but rather on the nearly simultaneous development of several interrelated strains of technology. The several strains, moreover, often reside in different scientific and technical disciplines. Innovation and the diffusion of innovation require a confluence of technologies, a confluence brought about by several firms whose primary production and marketing interests are not immediately and organizationally related.[1]

The innovative process is not uniquely dependent on technological feasibility. Technical feasibility is far from a sufficient cause for innovations. Introductions of new goods and services and of new means of production are as dependent on new organizational forms - on organizational innovations - as they are on narrowly defined technological innovations. Innovation occurs, that is, only when markets are structured and organized in a fashion such that those investing and participating in the new developments see reasonable probabilities of receiving benefits commensurate with their costs and risks. The actual innovations that do appear from what in perspective is a vast set of technologically feasible innovations are restricted to those for which there is an organizational structure that allows for the capturing of economic rewards.[2]

Organizational innovations are as important as the more obvious technological innovations precisely because they change the set of actual innovations for which rewards can be captured. To the extent that organizational structures do not coincide with those necessary to realize benefits from using feasible technological opportunities, the latter remain as "near technologies"; they do not become "in use" technologies.[3] Gradually - but only gradually - organizational innovations are arranged to accommodate the more apparent and the more potentially rewarding of the possible technological innovations. If the character of organizational innovation follows the patterns that now seem likely, the role of financial supermarkets will be a limited one and one that will depend on their being organizationally associated with other, smaller institutions.

2. A Digression on Market Organizations

It is customary to think of an "organization" as, say, a business firm, a bank, an investment company, a trade association, or as the governing body of an art museum, a transportation authority, a church or a hospital. These clearly are organizations, but the term has far broader connotations.

For present purposes:[4]

(a) An organization is a group of individuals (or a group of sub-organizations) the members of which can communicate with one another. Intra-group communications often utilize a "coded language" best understood by members of the group.

(b) The group has at least one shared goal, but the members are not interested in the shared goal(s) to the exclusion of other individual or subgroup goals.

(c) The collective accomplishment of the shared goal(s) requires compromise and conflict resolution, with trade-offs between the achievement of the collective, shared goal(s) and other individual or subgroup goals.

(d) For survivablilty, the organization must:

  i. provide perceptions to the members that the shared, collective goal(s) will be better achieved through concerted and coordinated group actions than it will through individual actions.

  ii. provide perceptions that the gains achieved by the organization with respect to the shared, collective goal(s) compensate for the compromises and trade-offs made with respect to other non-shared goals.

(e) The organization must in some fashion collect contributions (including foregone individual goals) from and distribute rewards (benefits) to the members.

(f) The organization provides rules (codes of conduct) with respect to intragroup relations and with respect to relations with non-members and other organizations.

(g) The organization provides internal governance mechanisms, usually fashioned by an hierarchical power structure, and enforces (more or less) the group's rules and mediates or resolves intragroup conflicts.

(h) The strength of individual member's identification with the group varies directly with the extent to which the group goals are congruent with individual goals and inversely with the extent to which the group goals conflict with the attainment of individual goals.

Participation in group activities is directly related to the strength of this identification.

In the case of an ordinary business the organization is formal and easily recognizable. It is formal in the sense of reasonably definable and measurable group goals, the need for coordinated activities to achieve the goals, defined functions of (contributions from) the employees, a defined system for distributing benefits (wages, salaries, profits, perquisites, etc.), established bylaws and work rules, internal enforcement mechanisms (fiat controls, incentive systems) and indeed, the "eager beaver" and the "drone" types of participants.

Many organizations are, however, less formal than that of a business. A carpool, for example, is an organization - an informal organization. So might be a joint venture among firms to develop the design and manufacturing method for a 1024K VLSIC. So are the relationships defined by McDonald's hamburger franchises. A family is an organization. Different types of organizations are used for different purposes in different circumstances. Formality - in the sense of charters, incorporations, bylaws, etc. - are not necessary for all collective purposes. Contracts, express agreements, tacit agreements and just plain "working relationships" constitute the corpus of many important organizations.

An individual does not "belong" to one organization to the exclusion of all others. An officer of a bank trust department and an officer of the commercial department of the same bank are each a member of the larger bank organization. Yet each is a member of a suborganization the goals of which may in some respects be in conflict within the bank. Each is probably also a member of separate family organizations, separate social and religious organizations and perhaps different political organizations. Each of these other, simultaneous group identifications may, to a degree, cause goal conflicts that require resolution.

Goal achievement is accomplished through organizations and is multidimensional. The individual tends to identify more strongly with and to contribute more to organizations the goals of which are congruent with his own and with respect to which perceived rewards are at least equal to contributions. This balance - or lack of balance - between individuals' perceived rewards from and contributions to various organizations is paramount in the explanation of organizational change. New organizations tend to appear when existing organizations are incapable of capturing and distributing benefits that some of the individuals perceive to be realizable through organizational innovations. The innovations may take many forms. The focus here is on interfirm organizational change, not on intrafirm changes, but the latter are in many contexts extremely important.[5]

One obvious interfirm organizational change is the merger of two or more organizations. Another is to "federate", with the creation of a supersidiary organization encompassing existing organizations. A holding company is an example of a formal supersidiary organization; an industry-wide trade association is another, usually less formal example.

New organizations may be formed that intersect with only selected parts of existing organizations. A joint R&D venture is an illustration. Such limited interfirm organizations are typically comprised of individuals who perform like functions in each of the firms - an organization, say, of the trust or of the data processing officers of several banks. Clearly, too, the organizational change may have the purpose of replacing or terminating an existing organizational arrangement - to dissolve a federation, a trade association or any other interfirm organization that is perceived to be ineffective in balancing rewards and contributions.

In this context, changes in technology - narrowly construed - offer opportunities for new rewards. Sometimes the rewards are achievable through existing organizational structures, but often they are not. Old organizations must be changed or new organizations created for opportunities to be translated from "near" to "in use" technologies.

3. Organizational Innovations and Financial Services: A Look at the Past

There are numerous illustrations of the interdependency of organizational and technological innovations in the history of financial services. Curiously, however, the organizational aspects of the changes are not typically emphasized. On examination it becomes clear that the service innovations and organizational innovations have transpired in a highly interdependent way.

3.1 Checkable Deposits:

Histories of the introduction and spread of checkable deposits emphasize that the innovation began in state banks in the post Civil War period after the imposition of the tax on state bank note issues. While true, these histories are also far too simple.

An individual bank - unless it were a near-monopoly bank over a substancial group of customers - could not easily and profitably have introduced checkable deposits by itself. If all checks written by any of its depositors were redeposited by others of its depositors, the new instrument would have had few problems. To the extent, however, that the use of checks by the customers of one bank depended on the acceptablilty of the checks by customers of other banks and, in turn, payments to other banks for settlement, a more general use of checkable deposits was necessary. Thus, the value of the new service to one bank (and its customers) depended on other banks (and their customers) having a similar service. And mutual use required a new interfirm organization.

The initial new organization in the U.S. was the local bank clearing house, or some modification of the clearing associations used previously for clearing bank note issues. The whole idea of clearing is that all of the members of the association, have items to be cleared or, in this case, that all of the banks have the new checkable deposits. Through the associations, the banks agreed on payment terms, settlement periods, the basic asset to be used to settle adverse balances, ways in which to handle fraudulently issued checks and checks against which there were insufficient deposits holder-in-due-course procedures and, clearly, the basis on which the ownership and costs of the clearing functions were to be shared. Since customers used both National and state chartered banks, the former had to be included in the clearing arrangements even though they initially had less of an incentive to use checkable deposits. The clearing houses were contractually arranged supersidiary joint ventures, vertically related to each of the participating banks. The diffusion of checking deposit banking depended on the new organizations.

The local clearing houses proved to be insufficient for regional and national checking, as it had been for note issues. The clearing house worked well so long as all of the checks presented to a member bank were drawn on another member. Checks drawn on non-member banks created problems. Non-members did not contribute to the costs of clearing these checks. This was true even if they were members of another clearing house.

The problem was resolved in three distinct ways. First, the local associations gradually organized regional clearing associations. Second, for non-members with some regular volume of checks or with other relations with one of the members, a correspondent arrangement could be established. The member bank cleared for and on behalf of its corresponding non-members on the basis of contracts. The latter usually provided for the non-member's holding of correspondent balances with the member banks.

The third way to handle non-member checks was to charge a fee. As checkable deposits spread, the fee was increasingly exacted by the receiving bank as a deduction from the face amount of the check. Checks from non-members were accepted at less than par. So called "non-par" banking yielded another problem, however. The spread in the use of checks as a means of payment was retarded. Payee's tended to refuse payments by check when less than the bill amount due were credited to their accounts.

History is again too simple or, at least, misleading. Non-par banking may to some extent have been caused by the questionable credit of the issuing banks, but that probably was not the major reason. The major reason was that if the receiving bank credited its payee customers the face amount of checks drawn on distant banks at the time of presentation, that receiving bank would in effect have been extending credit pending collection from the payor's bank. The payee's were unwilling to pay for this credit and so was the payee's bank. A larger, more comprehensive, national organization was needed to establish interfirm cost sharing if checks were to attain nationwide and general use.

No such organization arose for several decades, and the use of checks was restricted because of this fact. After the Federal Reserve System was established, it required all of its member banks to clear checks at par. The Fed also established its own means of extending credit so as to minimize the costs of par clearings. This was done through Federal Reserve float - the reserve account of the receiving bank was credited when checks were presented to a Federal Reserve Bank for clearing. The reserve account of the paying bank was debited only on its return to that bank by the same or another

Federal Reserve Bank. No bank paid explicit interest for this Federal Reserve credit.

Actually, even the Federal Reserve System was for years unable fully to solve the cost sharing and interfirm payments needed for nationwide check use. Non-member banks took advantage of the situation and behaved as "free riders". These banks - several thousand in number through the 1930's - provided checking accounts for their customers, relying on par payments by other banks even while they selectively received checks on other banks at less than par. The non-par banks received the benefits of the Federal Reserves's interfirm clearing subventions without contributing to the costs of the system.

It is clear that checkable deposits could hardly have been introduced in the absence of contemporaneous innovations in the functions of clearing associations. A new interfirm organization involving many banks was needed. Even had the larger banks made more extensive use of correspondent relations for check clearing within the set of banks covered by correspondent contracts, a clearing arrangement among the larger banks would have been necessary for system efficiency.

Note too that the attractiveness of checking was affected by other technological developments only remotely related to financial services. In particular, improved rail transportation and telegraph services were instrumental in extending the geographic area over which clearing could be efficiently performed. The period for which float had to be extended fell as transportation improved. The telegraph allowed for crude versions of electric funds transfer - thus also reducing float - and permitted the use of some check verification procedures.

3.2 MICR Encoded Checks:

The development of MICR (Magnetic Ink Character Recognition) encoded checks represents more of a process innovation than a service innovation.

The diffusion of MICR, nonetheless, makes clear several important points relating to the organizational innovations required for the use of new technologies.

MICR arose directly from an American Bankers Association task force, the Sub-Committee on Mechanization of Check Handling, which was created in 1954. There would hardly have been such a committee, however, in the absence of fundamental innovations in data processing, and the latter were motivated by factors quite apart from financial services. There were, that is, technological opportunities the major components of which existed for reasons exogeneous to the burdens of manual check handling.

Use of these opportunities for electronic clearing obviously depended on the nearly ubiquitous introduction of a single system. While banks might be furnished MICR equipment from several manufacturers, the value of the equipment depended on its ability to read information from checks drawn on any bank. Standards were required before character recognition could be economically employed. These standards had to be compatible with manual sorting during the transition to electronic sorting. Further, the concommitant check punching format had to be universally accepted so that MICR could be extended to the information systems within and among the participating banks. The R&D underlying MICR thus included interfirm organizations of equipment suppliers as well as the interfirm organizations of the financial institutions.

All banks did not have the computational capabilities required by MICR. Thus, as in the case of the clearinghouse, other organizational innovations were essential. The correspondent system changed to include MICR check processing by host banks. Service bureaus for data processing operated by non-bank firms appeared. Some banks began proprietary joint ventures for MICR check handling and other computational services.

No single bank could have profitably introduced MICR. It required many banks. No single manufacturer of data processing equipment could profitably have developed a specific MICR technology without an organizational arrangement with many banks. The latter, to preserve competitive options, required the other equipment manufacturers not to be foreclosed. The interfirm organization was a complex one.

3.3 Bilateral Contracting and Financial Services:

The use by a bank of services provided contractually by another firm has hardly been restricted to ordinary correspondent and data processing services. Loan participations are ad hoc interfirm organizations that permit a single bank to offer services to some customers that would otherwise be impossible or improvident. In the same way, National banks that were prohibited until 1913 from having their own trust departments entered into contracts with state chartered banks so that they could indirectly provide those services. Even today the trust services of many smaller banks are made available in part or in full through interbank contracting. Similarly, the early restrictions on real estate lending by National banks could be partially overcome by informal contracting between a bank and a savings and loan association or a mutual savings bank. After the Banking Act of 1933 and its Glass-Steagall provisions were enacted, many banks continued at least restricted securities brokerages services - "upon the order and for the sole account of customers" - with organizational arrangements effected with a security dealer. The more recent "sweep balance" accounts are modern versions of the same sort of interfirm organizations.

Interfirm correspondent relations, loan participations, trust services, and "sweep balance" services may often provide services more efficiently when organized through bilateral contracting than would a full merging of the affected businesses. So long as each of the parties is of sufficient size and scope in its general operations so that a full merger would not lower the costs of all of the sources of the banks involved, the fact that the contracts are restricted to limited activities does not exact cost penalties. Bilateral and multilateral interfirm contracting works quite well if the activities covered by the contracting do not require one or the other of the parties to invest substantially in capital that is idiosyncratic to the transactions, if the costs and benefits of the transactions from the point of view of each of the transactors are identifiable and largely independent of other activities of each, and if there are not foregone cost reductions or increases in benefits due to failures to include other parties in the contracting.[6]

3.4 The Bank Card Innovation:

The introduction of bank cards provides an excellent illustration of how more complex organizational innovations are needed in order to implement technological opportunities. The basic idea, like that of the check, was simple; as with the check, however, broad usage was required to bring forth the efficiency characteristics of the new service.

The value of having a card to a cardholder depends on the number of vendors of goods and services who will accept the card. If only an isolated merchant will take the card, there is little advantage in having one. The traveller would still have no good alternative to carrying cash or travellers checks. And the person who wanted consumer credit in making purchases would similarly gain little over other available credit sources.

On the other side, the value to vendors of accepting card payments depends, among other things, on the number of cardholders who wish to use it at their locations. A large base of cardholders promises higher sales, the avoidance of losses on credit the merchant would otherwise extend, reduced costs for credit investigations, immediate cash proceeds from sales to credit customers, reduced costs and loss from handling cash or checks, and improved internal control techniques.

If - as was not the case - a single bank were of sufficient size to operate its own card system, all aspects of pricing and system design could be internalized in that bank. When a cardholder purchased anything through use of the card, the merchant could return the sales paper to the bank, where the cardholders account would show a credit extension or the debiting of a deposit account. The merchant's account at the same bank would be credited.

With only one bank, there would be no problems with respect to cost sharing or interbank clearings. There would, however, be a pricing problem. For the most part, the bank's potential cardholders would be unwilling to pay much for the card itself or for card-based transactions. Cash, checks and merchants' own revolving credit schemes were good substitutes for many consumers for purchases from the merchants from whom most purchases were made.

Given the limited attractiveness of the card to purchasers, the merchants themselves would similarly be unwilling to pay much toward the operation of the system. They would gain few customers and some merchants might lose some of the profits from their own revolving credit plans. Thus, except for revenues that the bank could realize from consumer credit extensions, there would be few if any perceived benefits to any of the participants - the cardholders, the merchants and the bank - from the innovation. The bank card would not fly in the market place.

The interfirm organizational change that took place to make bank cards popular is well-known. The VISA and MasterCard organizations are the examples in this country. These interfirm organizations provide mechanisms necessary to make the bank card innovation a reality.

What are these governance roles? First - and this is as essential for the cards as for checks - the card issuing bank must accept the obligations generated by cardholders as these obligations are presented for payment. The acceptance has to be in terms that are certain with respect to time and amount. Were this not true, merchant banks and, in turn, merchants would be less willing to accept cards. Second, and again as with checks and particularly MICR encoding, the participating banks have to agree on card, paper and computational formats such that efficient data processing can occur on a systemwide basis. Thus, the initiation of processing at merchants' locations, even when these are essentially manual, must be in a form readable by all issuing banks for the system to work. The processing of merchants' paper at merchant banks has also to be largely independent of the particular issuing bank for efficiency.

There is a third and very important governance function that the interfirm card organization has to perform. If only one bank were involved, all of the paper generated by customer-merchant transactions would be the so-called "on us" paper. For a transaction of $X between a merchant and a cardholder, the former might receive $(X-a) and the latter might pay $(X+b), with $(a+b) being the bank's gross profit on the transaction. Nonetheless, no interbank clearings would be required. The merchants' and the cardholders' accounts would "washout" within the bank.

When there are many banks in the system, the "washout" exists within the interbank organization but it does not exist within a single bank. There is still but one basic transaction for each piece of paper, but different banks are involved. A merchant has sold for a price of $X some item for which the cardholder is ultimately to pay, but the bank that has contractually agreed to pay the merchant some $(X-a) is not ordinarily the same as the bank to which the customer has contractually agreed to pay some \$(X+b).

Each of the participating institutions recognizes in a more or less defined way that there are costs associated with effecting a transaction. Each may see some other benefits from its offering the bank card service. Card issuing banks and cardholders contract bilaterally with respect to the \$b. Merchant banks and merchants contract bilaterally with respect to the \$a. Then somehow there must be a division of the sum of all the \$(a+b)s the shares of which, together with the other perceived benefits, will make each of the participating banks willing to bear their respective costs. Since each must participate for the basic transactions between cardholders and merchants to occur, the condition that incremental benefits be at least equal to the incremental costs exists for each bank, not just for the interfirm bank card organization as a whole. The interfirm governance mechanism designed to overcome this problem was the interchange fee along with a central clearing organization.

Conceptually, and ignoring prohibitive state and federal laws, mergers among banks would be an alternative to the interfirm bank card organization. Were that chosen as the organizational mode, the governance provided now by interfirm bank card organizations would have been done internal to the merged firm. The required scale of card operations was achieved by contracting rather than by a massive merging of banks. As a result, competition among banks and market forces have determined the \$a and \$b prices. The interfirm organizations were necessary for the bank card innovation and in this case created opportunities for increased competition in the services being rendered to merchants and to cardholders.

4. Organizational Innovations and Financial Services: A Look at the Future

The organizational innovations that have been discussed are but a small fraction of those that have taken place in recent years. Others include automated clearing houses (ACH), hundreds of automated teller machine (ATM) networks, a few point-of-sale (POS) networks combined with ATM networks, new domestic Bank Wire arrangements, and the SWIFT and CHIPS systems for international payments. All are interfirm organizations, with horizontal and vertical elements among the main participants and essentially vertical, bilateral contracting between the main participants and other institutions with which they "correspond". The several interfirm organizations intersect with one another - effecting transactions that involve more than one organization - through multiple organizational memberships by individual institutions and through the governance mechanisms of interorganizational organizations.

4.1 An Array of Possible Future Services

The present menu of technological opportunities goes well beyond anything now in place. Computer and communications technologies are expanding the timeliness, comprehensiveness and reliability of information available to transactors. The same technologies are reducing transaction costs. Asset and liability management by households, non-financial businesses, and deposit and non-deposit financial institutions can be affected through electronic transactions among and within the historic organizational classes.

Only a minor part of the technically feasible new services has thus far emerged. To emphasize this, consider the services that might be made available through videotex and Teletext systems.[7] Start with a view of what really is a technically feasible system as seen by a household. Sophisticated terminal devices would be capable of accessing:

- deposits financial institutions for transactions

- organized securities, commodities and foreign exchange markets for transcations
- data banks of current and historic personal and general information
- data processing services, with sundry software-firmware packages and flexible user programmability
- account information from vendors of goods and services
- order and account servicing with vendors of goods and services
- general information services such as common directory information, schedules, news (local, regional, national, worldwide, with classifications by type), and weather
- word processing systems with capabilities for transmission, receipt, editing and output to varieties of "hard copy" formats at different locations
- voice communications, both "on line" and stored
- audio and video entertainment services, both "on line" from network providers and through suppliers of stored, user-retrievable programs.
- user owned and/or controlled memory (storage) and processing facilities
- emergency and alarm services, both monitored and user controlled
- educational and social services

Behind such terminals there would exist transmission links. These links would for some sources be switched networks, capable of handling "on line", multi-way interactive communication. For other services, one-way links would be adequate. Some services would require voice band channels. Digitization of analog signals would occur at the terminals.

For many of the services, the transmission links would switch to large numbers of service providers - the financial institutions, non-financial businesses, data bases, computer services, and the various information and entertainment services. In other cases, there would be switched networks between households and between financial and non-financial businesses. Some financial and non-financial businesses would provide state-of-the-art terminal devices for access by those without their own terminals as well as for use by persons away from their own terminals.

4.2 Economies of Scope and the Production of New Financial Services

While there has been no experience with so comprehensive a system, it is probable that system costs would reflect economies of scope. That is, the costs of providing a number of the services through a single organization would be less than the costs of providing the services individually with separate organizations. Thus, as was seen long ago by planners of "wired cities", local loops that carry a multiplicity of communications services are more efficient than are multiple systems of local loops, with each system dedicated to one or a few services. Scope economies in local loops would indicate that financial services would be provided on much the same facilities used for other services.

The same cost characteristic is likely to exist for modern versions of interexchange transmissions, whether by terrestrial fibre optic links or by earth satellites. Costs on a given link tend to fall as the channel capacity and use density of the link increases. Further, networking economies arise as an increasing number of nodes are interconnected with commonly controlled alternative routing capabilities. Again the joining of financial and other services is suggested.

The extent to which scope economies will prevail in terminal and interexchange switching is not clear. Switching technologies appear to be moving toward the common handling of digitized signals, whether those are signals for voice, data or video services. It seems probable that coding at the terminals by users - much like that in today's telephone network - will direct particular types of messages from one switch connecting many more users onto more specialized subnetworks with switches and interexchange links designed for those particularized message types. Some use related switching may be done at the terminals although switching further out in the network would likely be more efficient in most cases. Financial services generally and some specialized types of those services would, it appears, utilize unique subnetworks in the complex network of networks.

Terminal devices will also exhibit scope economies. A single video display unit and/or a single hard copy printer would be used over a wide range of services. Access to many data banks and to several processing/computer services would be joint, on common terminal equipment, as would be that for entertainment, news services, etc. Once more, specialized terminals for some financial services would be probable, but these would still interconnect for joint use of other parts of the global system.

The existance of scope economies does not necessarily preclude there being several competitive arrangements available to users. That is, the economies of scale need not be so extensive that only a single system could exist. Several purveyers, each offering a broad range of competitive services, could be formed. And it is possible also that the range of the scope economies would not be co-extensive with the set of feasible services. Thus, there is no reason to assume that "natural monopoly" cost conditions would exist over all or even a large part of the full communications system. In fact, a very competitive situation is more likely in the provision of financial services.

4.3 Limitations on System Implementation

It is extremely unlikely that any system approaching that which is technically feasible will soon appear. And the reason for this is obvious. Creating an organizational structure that would satisfactoriiy govern such a complex system is all but impossible.

Returning to the history of financial innovations. The introduction of checkable deposits depended on many banking institutions relatively simultaneously being hooked into the system. Too many checking transactions moved to outside institutions for a single bank to make checking a successful venture. The need for linking numerous financial institutions - and households and non-financial businesses - is even more important for the present electronic technologies.

The local or regional clearing house was an adequate interfirm organization to get checkable deposits into being. But in that case, there was a single type of instrument involved in the clearing. Beyond a bit of legal wording on the checks, each bank's checks could quite independently be prepared, issued, used by customers and cleared with few worries about technical compatibility and the encoding of data into commonly readable language. Now the technology covers many transactors, many types of instruments, hierarchies of clearing functions and settlements in several dimensions.

The clearing houses had problems in arranging support for the functions that at once provided incentives for widespread participation and avoided free riders. These problems are far more acute with a full-fledged electronic payments system. And there is an added difficulty. Because of the economies of scope, the incremental cost of adding a service to an existing system will be low. Further, the sum of these incremental costs may be less than the full cost of the system even though the sum of the prices charged for the system's functions will be designed to cover costs. Thus, some services will of necessity be priced above incremental costs, leaving a system operator exposed to strategic, incremental cost pricing for the same services by another operator.

This kind of exposure to the strategic and opportunistic behavior by others mulitates against investments in highly idiosyncratic, specialized capital.[8] Put another way, in the absence of a protective interfirm organization that prevents such exposure, the focus of investment will be on facilities that have relatively good alternative uses.

The history of MICR encoded checks tells a further story. Here the innovation required not only banks but also the participation of hardware and software manufacturers in the development process. In comparison with the number and diversity of participants needed to develop a system encompassing today's technological opportunties, the MICR development was indeed simple. Banks, other deposit institutions, securities and commodity dealers, insurance companies and various types of retailers and service vendors would be involved. So too would computer and terminal manufacturers, common and private telecommunications carriers, software suppliers, and providers of data bank and related services.

Bilateral contracting between primary participants and others with whom they might deal would create an organizational milieu somewhat responsive to the system's scope requirements. Nonetheless, contracting is hazardous. The writing of comprehensive contingency provisions would be burdensome. Contract enforcement is both risky and costly. Opportunistic breach of contracts - particularly in an environment with unforeseen changes in technology and markets - is difficult to prevent. Again, investments in the idiosyncratic capital needed for the complete system would be deterred.

The development of bank cards illustrates another difficulty. The value of a cardholder's having a card depends on the number of merchants and other source providers who honor the card. At the same time, the value to merchants in accepting a card depends on the number of cardholders who are likely to use the card in payment. This type of demand externality applies with added force in the complex services being discussed here. The value of each part of the system to each user of the system depends on the number of other users and the generality with which that part interconnects with other parts. Thus, what one party is willing to invest in facilities depends on what others are investing in complimentary facilities. And what one user will pay to use the system depends on the amounts of its services being purchased by others.

These externalities lie behind the dilemma of appropriately sharing costs and benefits. On a broad scale, the technologies may promise benefits that far exceed costs. At the same time, there is no organization of sufficient scope to collect the attendant potential revenues and to compensate those incurring costs in a manner that assures efficient deployment of the technically feasible system. Significant organizational innovation is required before the technology can be used.

5. An Evaluation of Future Financial Services

The organizational limitations are hardly so severe that significant new services will not appear. Some of the new technology is usable within the present interfirm organizational context although even here a need for interfirm organizational change is typical.[9] Other aspects of the technical developments of new source offerings can be accommodated by interfirm organizational changes of a modest sort. This has been seen for example, in the networking of ATMs among banks and between banks and investment companies in money market funds and sweep balance services. It is to be anticipated that more such reorganizations will occur.

More formal reorganizations predicated on the creation of a governance mechanism running across traditional service are also apparent. A number of so-called supermarket financial firms are being formed by merger. Much publicity has attended these consolidations. In the context of technical feasibility, however, none of these mergers goes far toward encompassing the potential for the production and distribution of financial services. It is, moreover, unlikely that any one or even the group of them will by themselves go far in this direction.

The supermarket organizations may be the leaders in service innovations. But as they innovate the boundaries of a strictly internally governed, single firm organization will be quickly realized. They may produce and distribute the entire amounts of some of their service but they will increasingly be forced into contracting modes for the production and distribution of others. Smaller institutions that reach customer groups otherwise unavailable to the large firm will be included. The supermarket firms, that is, will sell some services to and through other financial firms and buy some services from other financial and non-financial firms.[10]

Whether provided by a supermarket or more specialized firms, new financial service offerings will be severely circumscribed by developments outside of the finance area. The sweep of developments in computer technology is affected to only a minor extent by the needs of financial markets. The same is true of terminal equipment. Local, regional, national and international telecommunications networks - digital local networks, new switching equipment, new network control devices, deployment of fibre optics, etc. - will for the most part be responsive to general demand and technology conditions of which financial services are a small part. Thus, the outer limits on the pace of innovation will in large measure be set by forces not at all unique to financial service needs. It is only at the margin where an added financial service has apparent incremental value adequate for the special adaptation of technologies that these services will dictate the directions of progress.

It is from the near-ubiquitous character of the basic technologies that one finds assurance the financial supermarkets will not dominate the market place. What is transpiring is a revolution in the creation, dissemination and processing of information. Financial institutions are being affected by this revolution but are not terribly significant in shaping its overall directions. Since there are so many other actual or potential participants, and since the possibility of preemption of the technology by any form or industry is extremely remote, non-financial firms can host the development of financial services. Innovative entrepreneurial ventures can be launched not just by banks, other deposit institutions and investment and brokerage firms but as well by insurance companies, bank card organizations, data processing firms, computer and terminal manufacturers, operators of communications network, any large users of these networks, or some combinations of these.

Firms engaged in these activities can as well enter one or more selected lines of financial services. This possibility is augmented if the firms are able to enter without major investments in specialized capital, and with more intensive application of facilities used in common for other non-financial services. Contracts and franchising with existing financial organizations round out the organizational structures needed for such entry. There may be a natural proclivity to price these selected service offerings at levels below those of integrated financial supermarkets - so long as incremental revenues exceed incremental cost. Here is a major element in the competitive environment of all of the innovators, large or small, multiproduct or specialized. The scope economies associated with the technologies produce numerous potential competitors, coming from various prior market bases.

At the same time, the financial institutions can potentially enter these non-financial lines of business. Existing regulations inhibit some such entry, whether de novo, by merger or through joint ventures. Nonetheless, banks may be as inclined to engage in, say, data processing services, based on incremental costs, as are the data processing firms inclined to enter banking services. Thus the burden of erecting interfirm organizations for selective entry is relatively light even while that of broad entry over the range of technically feasible outputs is prohibitive.

The process of change will then be gradual even if the eventual revolution will be profound. Despite the gradualism, there will almost certainly be continued interorganizational consolidations. Efficiency gains will be one reason for mergers and joint ventures. In other cases, the process of change will itself force consolidations. Firms that make no effort to adapt to the new technologies will fail. So too will firms that move too fast - before the technology or markets are adequately defined - or that err in judgments of costs and revenues. Some interfirm organizational innovations will succeed, others will fail.[11]

6. Some Considerations of Public Policy

6.1 Antitrust Concerns

The apparent but limited efficiency of interfirm organizations in accommodating the provision of new financial services does not mean that there are no policy problems associated with their formation and operations. At the same time that the organizations make possible the production and distribution of of financial services that would not otherwise appear, their governance may at times extend to dimensions of conduct for which there is no social efficiency rational. Clearing houses, for example, were historically the locus for combinations in restraint of trade with respect to interest rates, banking hours, and other matters.

While interfirm agreements that have no purpose other than to restrain competition ought not be condoned, it is not always easy to distinguish those restraints on conduct that are essentially anticompetitive from those that are not. Moreover, the present status of antitrust law is not such that the legality of particular interfirm organizational arrangements can be determined with certitude prior to their initiation. Rules of an ATM network with respect to entry and access by non-members, for example, may seem reasonable to the organizers but quite unreasonable to others - as well as to a regulator or a court. Similarly, interfirm cross-payments designed to share common costs or to allocate revenues could conceivably be regarded as per se violations of the Sherman Act even when they in fact encourage competition and when without them the financial service would not be available.

It is perhaps true that the Department of Justice would not likely bring cases against interfirms organizational arrangement that yield net social benefits. Private suits, nonetheless, do not have the merits of social benefits as their foundations. They are predicated on injury to an actual or potential competitor or class of competitors and may succeed on just these grounds. It is not clear that the probablity of private litigants being awarded substantial damages now deters the formation of efficient interfirm arrangements, but it may.

There is a danger too that successful innovation will result in charges of monopolization and predation. The displaced producers of existing products often can point to particular aspects of the successful organization's conduct that appear monopolistic to them. The same is true of competitive but unsuccessful innovators. When entry is facilitated by prices based on the incremental costs of selective new product lines, these suits may succeed even when the practices yield socially beneficial consequences.

6.2 Monetary Policy

There is another policy matter that desperately requires attention. The introductions of new financial services over the past decade have already yielded a situation that hopelessly blurs the distinction between those liabilities of financial institutions that are essectially "money" and those that are not "money". The larger the array of assets that can be rapidly and efficiently exchanged for one another, the less distinct will be the advantage of anyone of them as a medium of exchange. Monetary policy based on controls over the quantity or prices of any defined set of financial institution liabilities is - in an electronics age - apt to lead only to the increased use of another type of liability. That, in brief, is what led to the rapid increase in money market funds, repos, commercial paper and Eurodollars in recent years.

As new technologies increasingly permit the exchange of any asset, by anyone, at any time, anywhere in the world, revisions in the very fundamentals of central banking and monetary policy will be needed. These revisions are not impossible, but they too will require organizational changes that will not be easy to fashion.

FOOTNOTES

[1] See Steindl (1980) for a discussion innovation as a combination of several techniques.

[2] The seminal work bearing on this point is Arrow (1962).

[3] See de Solla Price (1980). This article discusses relations between science and technologies and uses the phrase "almost technologies" to describe things we know how to do but have not put into practice.

[4] The following is based on Phillips (1962), March and Simon (1963) and Stinchcombe (1964).

[5] For modern treatment of the view that internal firm organization is important, see Williamson (1975).

[6] On the problems of using contracts rather than integration, see Williamson (1979) and Phillips (1980).

[7] In popular usage, videotex involves the transmission of information from data banks over telephone lines and cable. Teletext transmissions are broadcast or utilize cable TV channels. These distinctions are not important for the present discussion. For background, see Woolfe (1980), Sigel (1980), Martin (1978).

[8] See Williamson (1979).

[9] For discussion, see Macmillan (1982).

[10] For a concurring view, see Gerstner (1953).

[11] See Phillips (1971) and Nelson and Winter (1978).

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FINANCIAL SERVICES INDUSTRY—OVERSIGHT
Part II

MONDAY, JUNE 27, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met, at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Gorton, Hecht, Trible, Proxmire, Riegle, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order. I appreciate the willingness of this very distinguished panel, seven chief executive officers, to all be here together today on a Monday morning, competitors in many different fields, but friendly competitors, I hope.

Our financial system is continuing to undergo rapid changes, as I have said on many occasions before this committee. And this is the 13th day of hearings with over 60 witnesses that we have had on the competition within the financial services industry.

When we were starting the hearing process 2 years ago that resulted in S. 1720 and ultimately Garn-St Germain, the focus had been primarily at that time on the conditions of the thrift institutions, and this time it has been much more on the structure, competitive structure of the financial system, the uniqueness of the banks in the system, the roles played by Federal and State regulators and supervising participants in the system.

Now that the hearings are concluding—and this will be the final week of these hearings, the legislative issues mainly concern the nonbank-bank moratorium and substantative legislation, perhaps a Treasury separate subsidiary bill—as a matter of fact, I do believe Secretary Regan will have that bill to me this week and I will also submit that to the Congress by request.

Hopefully, as a result of these hearings, and various proposals submitted to the committee, we will be able to make some sense out of the events that are taking place in the financial system.

The nonbank-bank moratorium is, of course, a very hot issue at this time. I personally do not favor a moratorium. The reason I don't is that they are normally used as just an excuse to delay. If we could have a 6-month moratorium—this committee and the Congress—if we are willing to proceed and willing to make decisions on many of these issues, then I would not object to it. But I have yet to see a moratorium where we did anything but at the end of the moratorium extend it. I am afraid it is always used by the Congress as an excuse for not making some of the difficult decisions that need to be made.

Most of these issues that we have had over the last 2½ years are not new issues; they have been around a long, long time. We developed a couple thousand pages of testimony on them 2 years ago, as I have said two or three times, 13 hearings so far this year. I can't imagine that anything new or different could be said by anyone that we have not already received at one time or another.

So we are actually, in my opinion, down to the point where it simply is a matter of Congress willingness or lack of willingness to make some decisions, to decide what a nonbank-bank is, to decide what we are going to do with Glass-Steagall, and what the separation should be between commercial banking and investment banking and decide what we are going to do with McFadden.

Do we have reasonable interstate banking? Do we open it up, do we keep it the way it is? All of these are old issues that have been kicking around for a long long time.

It seems to me that if Congress would, we ought to be able to make some decisions. I would prefer to immediately, this summer, introduce legislation, have specific legislative hearing and by September or October mark up a bill. There is very little possibility of that, and I think a moratorium only guarantees that we will defer making those kinds of decisions.

In any event, gentlemen, I do very much appreciate your attendance here today for all of your schedules are very busy, for some of you it was particularly difficult for you to be here this morning.

So on behalf of the committee we do appreciate it very much.

Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator **Proxmire**. Thank you, Mr. Chairman. The oversight hearings you have held on the financial services industry have revealed a pervasive tension. The tension arises from a conflict between the ambitions of many corporations to expand into full-scale financial supermarkets, offering a wide range of financial services, and our present banking laws which seek to limit concentration and separate the business of banking from other commercial and financial endeavors.

Today we hear from executives from seven of our largest and most successful corporation, which are responsible for much of the tension.

I don't say this in a critical spirit. In a dynamic and growing economy, a certain amount of tension is to be expected and is to be welcomed. Tension is the inevitable byproduct of innovation and growth. A society, like an individual person, without tension is stagnant. Today we will view that tension from the perspective of some of those seeking change. We will be told that our present banking laws are no longer relevant in the marketplace today, that innovation and technical change have rendered these laws obsolete, that these laws should either be repealed or substantially changed.

Everyone is for innovation and technological change, especially when these changes lead to better services and products at lower cost.

However, we must be careful to carefully distinguish between developments in the marketplace spurred by new technology and those that arise from the age-old desire of participants to expand their corporate empire. There is nothing new or innovative about the desire of commercial banks to expand into the securities business. We tried that innovation in the 1920's with disastrous results.

It strikes me that many of the most recent so-called developments in the marketplace are not the product of technological innovation, but stem, instead, from the imperatives of corporate empire building. This is not to knock empire building. It is perfectly natural for an enterprise to want to expand and diversify its activities, especially when they have attractive, bright, and talented people looking for new worlds to conquer.

But the mere desire to expand does not necessarily mean it is good public policy, nor can we conclude that our present laws are obsolete or irrelevant simply because some firms have figured out a way to get around them through the creative exploitation of legal loopholes. If our banking laws are to be liberalized, the decision must come as a result of deliberate action by the Congress and not through the legal maneuvering of expansionist firms and their regulatory allies.

The two laws most seriously threatened by these legal innovations are the Glass-Steagall Act and the Bank Holding Company Act. Congress enacted these statutes to achieve specific objectives—to establish a safe and sound banking system, to prevent conflicts of interest in banking, and to limit the concentration of financial resources. These objectives were valid when the laws were passed and they remain valid today.

Personally, I am not prepared to see their wholesale repeal as some officials of the Regan administration have urged. Unless and until the Congress is willing to declare otherwise, the basic objectives underlying these statutes must be deemed to be the law of the land. That is why I favor the prompt enactment of the moratorium bill introduced by the chairman at the request of the Federal Reserve.

The purpose of this legislation is not to halt progress or stifle innovation; instead its purpose is to give the Congress a little time to consider the implications of recent developments such as the so-called nonbank bank and the South Dakota law.

The moratorium is a simple statute that contains no new issues not already covered in our hearings; it expires December 31, 1983, this year, in about 6 months.

So I would urge the chairman to schedule an early markup for this moratorium legislation and to establish a specific timetable for marking up the Treasury bill in the fall. I stand ready to assist the chairman in getting the committee to render a decision on these issues this year. There is no reason why we cannot reach a reasoned judgment by early fall, September or October. But we cannot conduct our business in an calm and deliberate fashion, if dozens or even hundreds of multimillion-dollar bank acquisitions are stimulated in order to get in under the wire of a pending legislative judgment.

There is always the danger, of course, that the moratorium might be used as an excuse by the Congress to postpone indefinitely the reconsideration of our financial structure laws, as the chairman just indicated might be the result. That certainly is not my purpose, and I am sure it is not the chairman's purpose. That is why any action on the moratorium must be coupled with a specific timetable for considering the underlying issues.

If this linkage is established, I believe a moratorium will not delay but will indeed hasten the need for examination of the need for further restructuring of the financial laws.

Therefore, Mr. Chairman, I repeat my request and urge you to schedule an early markup on the moratorium legislation, hopefully next week, and to establish a firm timetable for marking up the Treasury bill, or any other proposal in the early fall. Not next week, because next week we won't be here, so I presume it will have to be week after next.

The **Chairman**. I was going to say that, unless you are not going to give any Fourth of July speeches, which you always do, that we could do it the next week.

Senator Hecht.

Senator **Hecht**. No statement, Mr. Chairman. I am anxious to hear the panel.

The **Chairman**. Mr. Gorton.

Mr. **Gorton**. No statement, Mr. Chairman.

The **Chairman**. Senator Trible.

Senator **Trible**. No statement, Mr. Chairman.

The **Chairman**. Thank you very much. Today we have a distinguished panel of chief executive officers, I have wondered what the protocol should be and how we decide who should speak first. So I have resorted to a good old-fashioned American way of alphabetical order, not by name, but by company.

Therefore, Mr. Robinson is first, Mr. James D. Robinson, chairman of American Express Co.

STATEMENT OF JAMES D. ROBINSON III, CHAIRMAN, AMERICAN EXPRESS

Mr. **Robinson**. Thank you very much, Senator Garn. I am honored to be here with you today and delighted to be among a group of such able and yet friendly competitors.

As you well know, and stated very effectively, the financial services industry is undergoing dramatic change.

There is immense interest in the marketplace and demand for innovation and better service. In my view, this is the background against which any legislative action should be judged.

This morning I will try to contribute to your deliberations. My remarks today will review some history, discuss some desirable objectives, and briefly discuss some of the specific suggestions that have been put forth.

First, some history. The fundamental concerns about our financial system which grew out of the 1920's were largely eliminated by the strict banking laws of the 1930's. There followed several decades of stability and confidence in the markets. There was little demand for change and therefore little change in the basic services offered to consumers.

This period of the quiescent consumer came to an abrupt end a few years ago. Thanks to double-digit inflation and the resultant high and volatile interest rates, consumers were placed under severe strain. They began searching for, and demanding, a better deal.

The response was dramatic. I will not attempt here to list all of the innovations, but a striking example was money market funds that was probably the most dramatic market response during that period.

CONSUMERS CONTINUE THE DEMANDS FOR NEW PRODUCTS AND SERVICES

However, because of various regulatory restrictions, many of the new services could not be offered by all financial service companies. That is when we started hearing that wonderful phrase "a level playing field." Much was made of it in the hearings you held in 1981, Mr. Chairman. Since those hearings, the consumer has continued to demand new products and services; the industry has continued to innovate; and the rhetoric has continued to flow.

The provisions of the Garn-St Germain Act which permit depository institutions to offer money market deposit accounts provide a dramatic example of what can happen when new players enter a market. In 1972, money market funds did not exist. By 1982, their total assets had increased to $240 billion. Then the Garn-St Germain bill took effect in December of last year, and in the ensuing 6 months assets in the new money market deposit accounts have risen to over $360 billion, while those in money market funds have fallen to $167 billion. Clearly competition is dynamic when it is allowed to happen.

Garn-St Germain was a major step in addressing some of the more immediately perceived inequities. But the fundamental question of financial industry structure has been only partially addressed.

Where are we today? Luckily, we have seen significant improvements on the inflation front, and some improvements in interest rates, although not yet enough. Thus, consumers are not under the severe pressures they once were, but their demand for new and improved services continues to grow.

The period they have been through has permanently altered consumer spending and investment patterns. They are demanding and receiving a host of new products and services where they can choose a desired level of liquidity, convenience, risk, and return. Today Mr. and Ms. America are not about to accept anything less. I stress this because I believe it to be the single most important factor in the industry today. The changes in financial services have been, and will continue to be, consumer driven. I don't think the lid can be put back on the box.

People in the industry know this, and that is why you continue to see so many new alinements, techniques, and acquisitions. In an attempt to compete, legal loopholes are found and stretched. A new game has been devised involving State legislatures; some call it "rent a State," or "pick a regulator."

So, Mr. Chairman, on the one hand you are faced with the industry stretching the limits on their own and asking you or the States to remove or ease the limits legislatively. Some regulators are asking that Congress alleviate the stretching or decide actively rather than through inaction what the new limits should be. On the other hand, you also have the oldest game in town; financial industry segments jockeying for competitive advantage through regulatory restrictions.

FINANCIAL INDUSTRY FACING MANY UNRESOLVED QUESTIONS

That, in brief, is where we are today. Obviously, we are all faced with a great number of unresolved questions. There is no way I can address all of them. Let me give you, however, a few observations.

First and foremost, I hope you will resist the game of status quo or competitive advantage through regulatory restriction. The job of Congress in deciding upon modification of the legal and regulatory framework for our financial system for the years ahead is far too important. It should not be relegated to an exercise whereby Congress picks the winners and the losers. Besides, the public wants more choice, not less.

Do I think relaxation of restrictions is desirable? Absolutely. But I doubt that it is practical or desirable to give carte blanche. I testified in 1981 and reiterate today that Congress should review and modernize the laws where necessary.

My position on change was then, and is today, that: Rules which are outdated and stand in the way of innovation, especially technological innovation, should be modified. The marketplace should be given the broadest ability to be creative and be efficient, assuming suitable safeguards. The regulations should allow a diversity of both large and small financial institutions operating in this country. A safe and sound banking system should be assured. Reform should not weaken appropriate protection against conflicts of interest, self-dealing, and abuse of customer funds. Last, but not least, we must maintain a strong and independent Federal Reserve System.

That is a pretty tall order. But I do believe those are all very real concerns. And, since we are talking about a comprehensive review, Congress is certainly the most appropriate forum. It should be Congress who makes the decisions on a comprehensive basis, rather than leaving that principally to individual regulators or individual States. In fact, I suspect all these players have an important role to play. Remember that it is flexibility among competing entities, whether private sector or public, that is often the midwife of innovation.

Senator Proxmire put it as "tension" very well.

This brings me to the question of a legislated moratorium on certain acquisitions and preemptive State legislation. In principle I am opposed to such a moratorium. The talk about the possibility has already caused some companies to rethink their plans. An actual moratorium would stifle the creativity and expanded competition which is currently taking place in the marketplace. The losers would be the consumers.

Let's take an example, the nonbank bank. Right now institutions have a clear choice of being a bank in the traditional sense, being a nonbank bank in the emerging sense, or choosing to do neither, providing their financial services in other ways. Each of these options has clear advantages and disadvantages. Through this wide range of choices, companies can choose from the broadest array of services and delivery options. I think that is a pretty good result.

It is true that this has evolved through a so-called loophole. And the regulators are quite right in pointing it out, and even questioning whether Congress envisioned this particular effect when it drafted the original law. But that does not automatically mean that the result is wrong.

TEMPORARY MORATORIUM MAY NOT BE TEMPORARY

Moreover, I fear that a temporary moratorium might not be so temporary. Remember what happened with regulation Q. In 1966 Congress extended interest rate ceilings to deposits at S&L's and mutual savings banks. This was to be a temporary measure to protect thrift institutions during a period of rising interest rates. That "temporary" measure persisted for 17 years.

Finally, I fear that a "temporary" moratorium may serve to preserve the status quo and keep Congress from addressing the main task: Helping evolve a new financial regulatory structure for the decades to come.

I urge you not to be deterred from that task. And while you engage in it, remember that there are several sides to the stories you will hear.

The traditional depository institutions have certain advantages and protections that do not extend to nondepository firms, such as: Federal deposit insurance; access to the discount window; access to Federal Reserve payments system services; unique tax status; to mention a few principal ones.

On the other side of the coin, nondepository companies have: Freedom to offer a broader array of services; their supervision and regulation is segmented along functional lines; and they may innovate more freely because the regulatory approval for new products is less restrictive and bureaucratic.

Those on each side naturally covet the advantages they see on the other, and have been ingeniously seeking ways of getting there. This is perfectly natural. It is effective and it works. The job of Congress is to decide whether to permit this greater freedom to evolve this way, and if not, by how much, and under what circumstances.

I suggest, Mr. Chairman, that Congress, in considering further deregulation, evolve a set of principles that permits the broadest array of choices to the largest number of firms, consistent with the preservation of safety and soundness. Such a result will both serve and best protect the consumer.

The deregulation environment that you decide upon should permit all institutions an opportunity to survive and prosper. Our financial system will be best served, and capital will move most efficiently if the system is comprised of components of all sizes, types and design. Whatever you decide, American Express expects to be an active, effective, and I trust, successful player in providing services to a number of market segments in the global financial service marketplace.

Those are my views. Thank you very much.

The CHAIRMAN. Thank you very much,

I may say to the committee members, normally when we have a panel we would have all of the witnesses testify before going to questions. Mr. Robinson originally was not able to be here because of a board meeting at his company this morning, but he did come, and he hopes to get back to his board meeting before his board does something to him that he may not approve of.

So if we could deviate and if any of you have questions of Mr. Robinson, we would like to have them now so that he can get back and preserve his position with the company.

Mr. ROBINSON. Thank you, Mr. Chairman.

The CHAIRMAN. Are there questions?

RENT-A-STATE

Senator PROXMIRE. May I ask Mr. Robinson a question? Mr. Robinson, on page 5 of your statement you describe the process of finding and stretching legal loopholes, and a new game has been devised called rent-a-State.

Now if national policy can be overturned simply by renting a State, as you put it—that is not a very good way to put it, but that is what was done in South Dakota—this indicates a further need for a moratorium until Congress can either close the loopholes or modify the statutes?

Mr. ROBINSON. Senator Proxmire, again there are problems on both sides. I think the tension which is created by that process itself, because it is making things happen in the marketplace, may in fact be a more effective inducement to coming up with legislative changes to the extent desired than perhaps a moratorium might. There are two ways of looking at it.

Senator PROXMIRE. The fact is, though, you move into a situation like that and you have the astonishing situation of South Dakota saying sure, you can use our insurance company to sell insurance, but not in South Dakota. Delaware has the same kind of an operation, in different areas.

It just seems to me that it is so much better if we in the Congress look at this legislation carefully, and decide what should be the national policy as a comprehensive national policy.

Would your view be different? You are very much opposed to a moratorium, as the chairman of the committee is, but would your view be different if you could be assured that the chairman of this committee and the chairman of the House committee would schedule a markup of the Treasury bill so we could act on that in the fall and be assured that there was every reason to expect that the moratorium would be truly 6 months and that is it?

Mr. ROBINSON. Well, certainly if there were unequivocable guarantees the moratorium would be of limited life like that.

Senator **Proxmire**. You never quite get an unequivocable guarantee, but say do the best we could.

Mr. **Robinson**. It is hard to oppose it. But in principle it seems to me the pressures of that kind of activity are the reason we are here this morning. It is a question of which one gives the most effective inducement, it seems to me. It is not going to be the end of the world if you take a short period of time like that. But, I would be very careful about using that as the way to make things happen, as distinct from simply responding to pressures, which are happening because of a phenomenon. It is making a lot of money for the lawyers, I suppose.

Senator **Proxmire**. I know you have to get back to your board in order to keep it under control, but I am very very troubled with the notion that we are going to have a situation develop such as the South Dakota situation, and others, where we are presented with a fait accompli. The big institutions such as are represented here so well this morning have moved into situations and we don't want to try to unscramble anything. The situation has developed, perhaps developed with bad public results, and we are left with no choice except to permit the chaotic opportunistic developments to be taking place.

Mr. **Robinson**. I understand your dilemma.

The **Chairman**. Senator Heinz.

Senator **Heinz**. Thank you, Mr. Chairman. One of the things that you say, Mr. Robinson, that we should do in setting the limits, setting for the paths financial institutions may travel, is that we should evolve a set of principles that, among other things, is consistent with the preservation of safety and soundness.

It is my understanding that the Treasury Department is going to come down by the end of this week with a proposal which will include, among other things, their separate subsidiaries.

Now is it your view that an institution that has federally insured deposits, or an institution that may want to get into business that involves federally insured deposits, should, as long as they do whatever they do through a separate subsidiary, be allowed to engage in nearly any kind of business undertaking?

SEPARATE SUBSIDARY APPROACH

Mr. **Robinson**. It would be my view that if you are going to go in that direction, the separate subsidiary approach is the only approach to take, where in fact you have the various "functional" regulators reviewing the functional business. It is possible to set up the necessary checks and balances to allow the unique preservation by category, whether it is insurance, banking, what-have-you, to be attained.

I have not seen the details of the Treasury bill, so it is hard to respond. But theoretically I think that is possible.

Now the question of Federal deposit insurance, I think is an issue that should certainly be addressed, because right now, speaking of a level playing field, we certainly don't have one. For example, the money market fund industry which competes with the depositories doesn't have Federal Insurance. So there is a balance in there that always has to be viewed. And there is a question as to whether the way Federal insurance is presently designed simply subsidizes bad management as opposed to providing specific objectives of protecting the smaller depositors.

Senator HEINZ. Just so I understand your viewpoint, is it your view, for example, that a holding company that in effect owned a bank, nonbank bank, or bank, but there were insured deposits in one subsidiary, could or should be allowed to go into a risky business where it might lose its shirt, might make a billion dollars, kind of a 50-50 probability of one or the other, is it your view that in principle a separate subsidiary would be a guarantee of sufficient safety and soundness even if that half of the risky enterprise went bellyup?

Mr. ROBINSON. I would lean in that direction, because I think it can be done. If you look at the examples of bankruptcy today, a multiple company, even perhaps related to the financial area, where they have separate subsidiaries, often those separate subsidiaries are the most salable assets, because they have been run at true arm's length and they are indeed effective entities and have not been contaminated, assuming there is no problem, of course, with the actions elsewhere.

Senator HEINZ. One last followup, then we will let you get back to your board meeting.

We had a panel of academic experts here late last week. They all indicated that in their view there was absolutely—this is practically the only thing they agreed upon, four different experts with four different points of view, except the one thing—they all agreed, citing in effect the studies in North Carolina that are fairly recent, that there would be really no difference between allowing one company without separate subsidiaries to do all of the things we are suggesting they might do, and doing it through separate subsidiaries. They said there is no substantative difference other than possibly a small effect on conflict of interest problems.

But in terms of financial safety and soundness, they seemed to all agree there was just no difference doing it through separate subsidiaries.

Mr. ROBINSON. Here is one vote that disagrees with them. Having to put up with the lawyers and corporate veil, and everything in terms of setting the guidelines we live with daily, separate companies mean separate companies.

Senator HEINZ. Thank you.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Mr. Robinson, I know you have to leave, but I wonder this: Beyond opposing the moratorium, as it relates either to the structure of the financial services industry, which is essentially what we are addressing here, or just the whole question of the economic future, which is woven into it, but obviously stretches out into the economic conditions we are facing in this country, I wonder if you have anything you want to share with respect to what you would list as your greatest concern at the moment, either coming out of this discussion sort of structural arrangement, or coming out into the broader policy questions as to how we sort of move ourselves ahead without slipping backward?

Mr. ROBINSON. Well, I suppose our greatest concern would be a moratorium that becomes not temporary, or partial solutions which are piecemeal and simply slowdown some of the constructive developments that I think otherwise could take place.

Senator RIEGLE. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator GORTON. Excuse me, Mr. Chairman. Could I ask a question?

The CHAIRMAN. Yes.

Senator GORTON. A fairly basic question, Mr. Robinson. On page 2 of your testimony, you state: "The fundamental concerns about our financial system which grew out of the 1920's were largely eliminated by the strict banking laws of the 1930's." But you are, of course, an advocate of deregulation. What is different now that would make that deregulation and the entry into insurance and securities and the like differ in result from those of the unregulated 1920's?

Mr. ROBINSON. Basically I think that the system itself is substantially an order of magnitude more sophisticated today than it was then in terms of communications, checks and balances, the roles that boards of directors realize they have in being responsible for the affairs of an institution. And if they don't, some of the legal cases today have certainly encouraged them to do so.

I think that some of the fundamental motivations that were behind the 1930's laws on separatism should be carefully kept in mind, but a good degree of modification is possible, such as banks having the capacity to sell mutual funds, as distinct from totally the capacity to be an underwriter.

So there are shades and degrees of change which I think one could legitimately debate.

But basically the system today is capable, and the marketplace is capable, particularly if you make some adjustments in the FDIC, where one simply can't run a shop full speed ahead and say why worry, because if you get into trouble the Government will bail you out. Those checks and balances very much can be kept intact.

Senator GORTON. You are not saying the lessons of the 1920's are totally irrelevant?

Mr. ROBINSON. No.

Senator GORTON. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. Thank you, Mr. Robinson, we appreciate your being here today.

Mr. ROBINSON. Thank you, Mr. Chairman.

[The complete statement follows:]

STATEMENT
OF
JAMES D. ROBINSON III

CHAIRMAN OF THE BOARD
AND CHIEF EXECUTIVE OFFICER
AMERICAN EXPRESS COMPANY

THANK YOU, CHAIRMAN GARN. I AM HONORED TO BE HERE TODAY.

AS YOU WELL KNOW, THE FINANCIAL SERVICES INDUSTRY IS UNDERGOING DRAMATIC CHANGE. YOU CAN HARDLY PICK UP THE NEWSPAPER WITHOUT READING ABOUT SOME TYPE OF NEW FINANCIAL PRODUCT, A REALIGNMENT OF BANK AND NONBANK COMPANIES, OR A STATE GOVERNMENT OR REGULATOR MAKING A SIGNIFICANT REVISION. THE BOTTOM LINE IS THAT THE MARKETPLACE IS WORKING AND COMPETITION IS INCREASING.

WE NOW HAVE THE GREATEST VARIETY OF FIRMS OFFERING THE GREATEST VARIETY OF PRODUCTS AND SERVICES TO THE CONSUMING PUBLIC IN THE HISTORY OF THIS COUNTRY. WE SHOULD ALL BE APPLAUDING. THE GOAL SHOULD BE CONTINUED INNOVATION AND EXPANSION. THE MARKETS ARE CERTAINLY MOVING IN THAT DIRECTION AND I SUGGEST THAT CONGRESS SHOULD ENCOURAGE AND FACILITATE THIS MOVEMENT.

I BELIEVE THAT IS THE PERSPECTIVE WE SHOULD KEEP VERY MUCH IN MIND AS THE DEBATES CONTINUE ON SUCH THINGS AS EXPANDED OR LIMITED POWERS BY TYPE OF INSTITUTION OR WHETHER TO SPEED UP OR SLOW DOWN THE PROCESS -- OR WHETHER TO IMPOSE A MORATORIUM.

IN THE LAST SEVERAL YEARS, A WHOLESOME REVOLUTION IN THE FINANCIAL NEEDS OF THE CONSUMER HAS BEEN TAKING PLACE: THE ISSUE HAS BECOME --

- HOW MR. & MRS. AMERICA USE AND PROTECT THEIR ASSETS.

- HOW THEY PROVIDE CASH FLOW OR ACCESS TO AFFORDABLE CREDIT IN THEIR YOUNGER LIVES WHILE PROTECTING THEIR POST-RETIREMENT YEARS -- ESPECIALLY IN VIEW OF THE INADEQUACY OF OUR SOCIAL SECURITY FUND.

THERE IS IMMENSE INTEREST IN THE MARKETPLACE AND DEMAND FOR INNOVATION AND BETTER SERVICE. THIS IS THE BACKGROUND AGAINST WHICH ANY LEGISLATIVE ACTION SHOULD BE JUDGED.

THIS MORNING, I WILL TRY TO CONTRIBUTE TO YOUR DELIBERATIONS. MY REMARKS TODAY WILL REVIEW SOME HISTORY, DISCUSS DESIRABLE OBJECTIVES AND BRIEFLY DISCUSS SOME OF THE SPECIFIC SUGGESTIONS THAT HAVE BEEN PUT FORTH. FIRST SOME HISTORY:

THE FUNDAMENTAL CONCERNS ABOUT OUR FINANCIAL SYSTEM WHICH GREW OUT OF THE 1920'S WERE LARGELY ELIMINATED BY THE STRICT BANKING LAWS OF THE 1930'S. THERE FOLLOWED SEVERAL DECADES OF STABILITY AND CONFIDENCE IN THE MARKETS. THERE WAS LITTLE DEMAND FOR CHANGE AND THEREFORE LITTLE CHANGE IN THE BASIC SERVICES OFFERED TO THE CONSUMER TOOK PLACE.

THIS PERIOD OF THE "QUIESCENT CONSUMER" CAME TO AN ABRUPT END A FEW YEARS AGO. THANKS TO DOUBLE-DIGIT INFLATION AND THE

RESULTANT HIGH AND VOLATILE INTEREST RATES, CONSUMERS WERE PLACED UNDER SEVERE STRAIN. THEY BEGAN SEARCHING FOR, AND DEMANDING, A BETTER DEAL.

THE RESPONSE WAS DRAMATIC. I WILL NOT ATTEMPT HERE TO LIST ALL OF THE INNOVATIONS. A STRIKING EXAMPLE WAS MONEY MARKET FUNDS: PROBABLY THE MOST DRAMATIC MARKET RESPONSE DURING THAT PERIOD.

HOWEVER, BECAUSE OF VARIOUS REGULATORY RESTRICTIONS, MANY OF THE NEW SERVICES COULD NOT BE OFFERED BY ALL FINANCIAL SERVICE COMPANIES. THAT'S WHEN WE STARTED HEARING THAT WONDERFUL PHRASE "A LEVEL PLAYING FIELD." MUCH WAS MADE OF IT IN THE HEARINGS YOU HELD IN 1981, MR. CHAIRMAN. SINCE THOSE HEARINGS, THE CONSUMER HAS CONTINUED TO DEMAND NEW PRODUCTS, THE INDUSTRY HAS CONTINUED TO INNOVATE, AND THE RHETORIC HAS CONTINUED TO FLOW.

THE PROVISIONS OF THE GARN-ST. GERMAIN ACT WHICH PERMIT DEPOSITORY INSTITUTIONS TO OFFER MONEY MARKET DEPOSIT ACCOUNTS PROVIDE A DRAMATIC EXAMPLE OF WHAT CAN HAPPEN WHEN NEW PLAYERS ENTER A MARKET. IN 1972, MONEY MARKET FUNDS DID NOT EXIST. BY 1982, THEIR TOTAL ASSETS HAD INCREASED TO $240 BILLION. THEN, THE GARN-ST GERMAIN BILL TOOK EFFECT IN DECEMBER OF LAST YEAR. IN THE LAST SIX MONTHS, ASSETS IN THE NEW MONEY MARKET DEPOSIT

ACCOUNTS HAVE RISEN TO $360 BILLION, WHILE THOSE IN MONEY MARKET FUNDS HAVE FALLEN TO $167 BILLION. CLEARLY COMPETITION IS DYNAMIC WHEN IT IS PERMITTED.

GARN-ST. GERMAIN WAS A MAJOR STEP IN ADDRESSING SOME OF THE MORE IMMEDIATELY PERCEIVED INEQUITIES. BUT THE FUNDAMENTAL QUESTION OF FINANCIAL INDUSTRY STRUCTURE HAS BEEN ONLY PARTIALLY ADDRESSED.

WHERE ARE WE TODAY? LUCKILY, WE HAVE SEEN SIGNIFICANT IMPROVEMENTS ON THE INFLATION FRONT AND SOME IMPROVEMENTS IN INTEREST RATES; ALTHOUGH, NOT YET ENOUGH. THUS, CONSUMERS ARE NOT UNDER THE SEVERE PRESSURES THEY ONCE WERE, BUT THEIR DEMAND FOR NEW AND IMPROVED SERVICES CONTINUE TO GROW.

THE PERIOD THEY HAVE BEEN THROUGH HAS PERMANENTLY ALTERED CONSUMER SPENDING AND INVESTMENT PATTERNS. THEY ARE DEMANDING AND RECEIVING A HOST OF NEW PRODUCTS AND SERVICES WHERE THEY CAN CHOOSE A DESIRED LEVEL OF LIQUIDITY, CONVENIENCE, RISK AND RETURN. TODAY MR. & MRS. AMERICA ARE NOT ABOUT TO ACCEPT ANYTHING LESS. I STRESS THIS BECAUSE I BELIEVE IT TO BE THE SINGLE MOST IMPORTANT FACTOR IN THE INDUSTRY TODAY. THE CHANGES IN FINANCIAL SERVICES HAVE BEEN, AND WILL CONTINUE TO BE, CONSUMER DRIVEN. THE LID CANNOT BE PUT BACK ON THE BOX.

PEOPLE IN THE INDUSTRY KNOW THIS. THAT IS WHY YOU CONTINUE TO SEE SO MANY NEW ALIGNMENTS, TECHNIQUES, AND ACQUISITIONS. IN AN ATTEMPT TO COMPETE, LEGAL LOOPHOLES ARE FOUND AND STRETCHED. A NEW GAME HAS BEEN DEVISED INVOLVING STATE LEGISLATURES; SOME CALL IT "RENT-A-STATE", OR "PICK A REGULATOR".

SO, MR. CHAIRMAN, ON THE ONE HAND, YOU ARE FACED WITH THE INDUSTRY STRETCHING THE LIMITS ON THEIR OWN AND ASKING YOU (AND/OR THE STATES) TO REMOVE OR EASE THE LIMITS LEGISLATIVELY. SOME REGULATORS ARE ASKING THAT CONGRESS ALLEVIATE THE STRETCHING OR DECIDE ACTIVELY RATHER THAN THROUGH INACTION WHAT THE NEW LIMITS SHOULD BE. ON THE OTHER HAND, YOU ALSO HAVE THE OLDEST GAME IN TOWN: FINANCIAL INDUSTRY SEGMENTS JOCKEYING FOR COMPETITIVE ADVANTAGE THROUGH REGULATORY RESTRICTIONS.

THAT, IN BRIEF, IS WHERE WE ARE TODAY. OBVIOUSLY, WE ARE ALL FACED WITH A GREAT NUMBER OF UNRESOLVED QUESTIONS. THERE IS NO WAY I CAN ADDRESS ALL OF THEM . LET ME GIVE YOU, HOWEVER, A FEW OBSERVATIONS ON SOME.

FIRST AND FOREMOST. I HOPE YOU WILL RESIST THE GAME OF STATUS QUO OR "COMPETITIVE ADVANTAGE THROUGH REGULATORY RESTRICTION". THE JOB OF CONGRESS IN DECIDING UPON MODIFICATION OF THE LEGAL AND REGULATORY FRAMEWORK FOR OUR

FINANCIAL SYSTEM FOR THE YEARS AHEAD IS TOO IMPORTANT. IT SHOULD NOT BE RELEGATED TO AN EXERCISE WHEREBY CONGRESS PICKS THE WINNERS AND THE LOSERS. BESIDES, THE PUBLIC WANTS MORE CHOICE, NOT LESS.

DO I THINK RELAXATION OF RESTRICTIONS IS DESIRABLE? ABSOLUTELY! BUT I DOUBT THAT IT IS PRACTICAL OR DESIRABLE TO GIVE "CARTE BLANCHE!" I TESTIFIED IN 1981 AND REITERATE TODAY THAT CONGRESS SHOULD REVIEW AND MODERNIZE THE LAWS WHERE NECESSARY. MY POSITION ON CHANGE WAS THAT:

- RULES WHICH ARE OUTDATED AND STAND IN THE WAY OF INNOVATION -- ESPECIALLY TECHNOLOGICAL INNOVATION -- SHOULD BE MODIFIED.
- THE MARKETPLACE SHOULD BE GIVEN THE BROADEST ABILITY TO BE CREATIVE AND BE EFFICIENT -- ASSUMING SUITABLE SAFEGUARDS.
- THE REGULATIONS SHOULD ALLOW A DIVERSITY OF BOTH LARGE AND SMALL FINANCIAL INSTITUTIONS OPERATING IN THIS COUNTRY.
- A SAFE AND SOUND BANKING SYSTEM SHOULD BE ASSURED.
- REFORM SHOULD NOT WEAKEN APPROPRIATE PROTECTION AGAINST CONFLICTS OF INTEREST, SELF-DEALING AND ABUSE OF CUSTOMER FUNDS.
- WE MUST MAINTAIN A STRONG AND INDEPENDENT FEDERAL RESERVE SYSTEM.

THAT'S A PRETTY TALL ORDER. BUT I DO BELIEVE THOSE ARE ALL REAL CONCERNS. AND, SINCE WE ARE TALKING ABOUT A COMPREHENSIVE REVIEW, CONGRESS IS CERTAINLY THE MOST APPROPRIATE FORUM. IT SHOULD BE CONGRESS WHO MAKES THE DECISIONS ON A COMPREHENSIVE

BASIS, RATHER THAN LEAVING THAT PRINCIPALLY TO INDIVIDUAL REGULATORS OR INDIVIDUAL STATES. IN FACT, I SUSPECT ALL THESE PLAYERS HAVE AN IMPORTANT ROLE TO PLAY. REMEMBER THAT IT'S FLEXIBILITY AMONG COMPETING ENTITIES -- BOTH PRIVATE SECTOR AND PUBLIC -- THAT OFTEN IS THE MID-WIFE OF INNOVATION.

THIS BRINGS ME TO THE QUESTION OF A LEGISLATED MORATORIUM ON CERTAIN ACQUISITIONS AND PRE-EMPTIVE STATE LEGISLATION. IN PRINCIPLE I AM OPPOSED TO SUCH A MORATORIUM. THE TALK ABOUT THE POSSIBILITY HAS ALREADY CAUSED SOME COMPANIES TO RETHINK THEIR PLANS. AN ACTUAL MORATORIUM WOULD STIFLE THE CREATIVITY AND EXPANDED COMPETITION WHICH IS CURRENTLY TAKING PLACE IN THE MARKETPLACE. THE LOSERS WOULD BE THE CONSUMERS.

LET'S TAKE ANOTHER EXAMPLE: THE "NONBANK BANK". RIGHT NOW, INSTITUTIONS HAVE A CLEAR CHOICE OF BEING A BANK IN THE TRADITIONAL SENSE, BEING A "NONBANK BANK" IN THE EMERGING SENSE, OR CHOOSING TO DO NEITHER, PROVIDING THEIR FINANCIAL SERVICES IN OTHER WAYS. EACH OF THESE OPTIONS HAS CLEAR ADVANTAGES AND DISADVANTAGES. THROUGH THIS WIDE RANGE OF CHOICES, COMPANIES CAN CHOOSE FROM THE BROADEST ARRAY OF SERVICES AND DELIVERY OPTIONS. I THINK THAT IS A PRETTY GOOD RESULT.

IT'S TRUE THAT THIS HAS EVOLVED THROUGH A SO CALLED "LOOPHOLE". AND THE REGULATORS ARE QUITE RIGHT IN POINTING IT

OUT, AND EVEN QUESTIONING WHETHER CONGRESS ENVISIONED THIS PARTICULAR EFFECT WHEN IT DRAFTED THE ORIGINAL LAW. BUT THAT DOES NOT AUTOMATICALLY MEAN THAT THE RESULT IS WRONG.

MOREOVER, I FEAR THAT A "TEMPORARY" MORATORIUM MIGHT NOT BE SO TEMPORARY. REMEMBER WHAT HAPPENED WITH REGULATION Q. IN 1966, CONGRESS EXTENDED INTEREST RATE CEILINGS TO DEPOSITS AT S&L'S AND MUTUAL SAVINGS BANKS. THIS WAS TO BE A TEMPORARY MEASURE TO PROTECT THRIFT INSTITUTIONS DURING A PERIOD OF RISING INTEREST RATES. THAT "TEMPORARY" MEASURE PERSISTED FOR SEVENTEEN YEARS.

FINALLY, I FEAR THAT A" TEMPORARY" MORATORIUM MAY SERVE TO PRESERVE STATUS QUO AND KEEP CONGRESS FROM ADDRESSING THE MAIN TASK: HELPING EVOLVE A NEW FINANCIAL REGULATORY STRUCTURE FOR THE DECADES TO COME.

I URGE YOU NOT TO BE DETERRED FROM THAT TASK. AND WHILE YOU ENGAGE IN IT, REMEMBER THAT THERE ARE SEVERAL SIDES TO THE STORIES YOU WILL HEAR.

THE TRADITIONAL DEPOSITORY INSTITUTIONS HAVE CERTAIN ADVANTAGES AND PROTECTIONS THAT DO NOT EXTEND TO NONDEPOSITORY FIRMS:

o FEDERAL DEPOSIT INSURANCE;

- ACCESS TO THE DISCOUNT WINDOW;
- ACCESS TO FEDERAL RESERVE PAYMENTS SYSTEM SERVICES;
- UNIQUE TAX STATUS

TO MENTION A FEW PRINCIPAL ONES.

ON THE OTHER SIDE OF THE COIN, NONDEPOSITORY COMPANIES:

- HAVE FREEDOM TO OFFER A BROADER ARRAY OF SERVICES;
- THEIR SUPERVISION AND REGULATION IS SEGMENTED ALONG FUNCTIONAL LINES;
- THEY MAY INNOVATE MORE FREELY BECAUSE THE REGULATORY APPROVAL FOR NEW PRODUCTS IS LESS RESTRICTIVE AND BUREAUCRATIC.

THOSE ON EACH SIDE NATURALLY COVET THE ADVANTAGES THEY SEE ON THE OTHER, AND HAVE BEEN INGENIOUSLY SEEKING WAYS OF GETTING THERE. THIS IS PERFECTLY NATURAL. IT IS EFFECTIVE AND IT WORKS. THE JOB OF CONGRESS IS TO DECIDE WHETHER TO PERMIT THIS GREATER FREEDOM TO EVOLVE THIS WAY, AND IF NOT, BY HOW MUCH, AND UNDER WHAT CIRCUMSTANCES.

I SUGGEST, MR. CHAIRMAN, THAT CONGRESS, IN CONSIDERING FURTHER DEREGULATION, EVOLVE A SET OF PRINCIPLES THAT PERMITS THE BROADEST ARRAY OF CHOICES TO THE LARGEST NUMBER OF FIRMS, CONSISTENT WITH THE PRESERVATION OF SAFETY AND SOUNDNESS. SUCH A RESULT WILL BOTH SERVE AND BEST PROTECT THE CONSUMER.

THE DEREGULATION ENVIRONMENT THAT YOU DECIDE UPON SHOULD PERMIT ALL INSTITUTIONS AN OPPORTUNITY TO SURVIVE AND PROSPER. OUR FINANCIAL SYSTEM WILL BE BEST SERVED, AND CAPITAL WILL MOVE MOST EFFICIENTLY IF THE SYSTEM IS COMPRISED OF COMPONENTS OF ALL SIZES, TYPES AND DESIGN. WHATEVER YOU DECIDE, AMERICAN EXPRESS EXPECTS TO BE AN ACTIVE, EFFECTIVE AND I TRUST SUCCESSFUL PLAYER IN PROVIDING SERVICES TO A NUMBER OF MARKET SEGMENTS IN THE GLOBAL FINANCIAL SERVICE MARKETPLACE.

THOSE ARE MY VIEWS.

THANK YOU.

The CHAIRMAN. Mr. Armacost, BankAmerica.

STATEMENT OF SAMUEL H. ARMACOST, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BANKAMERICA CORP., SAN FRANCISCO, CALIF.

Mr. ARMACOST. Thank you, Mr. Chairman. I am honored to be here this morning and I appreciate this opportunity to appear before your committee.

Statement of

Samuel H. Armacost

President and Chief Executive Officer

BankAmerica Corporation

Thank you, Mr. Chairman. I am Samuel H. Armacost, President and Chief Executive Officer of BankAmerica Corporation, holding company for Bank of America. Bank of America is among the largest banks in the world and the leading retail bank in California. Our bank is proud to have played a role in California's economic development, and we continue to serve as the state's major lender for family housing, agriculture, and industry. I am honored by the Committee's invitation to testify as part of this panel on the future of financial services, and hope that my remarks assist the Committee in its deliberations.

Meeting customer demands for more sophisticated and diverse financial services is the greatest challenge facing commercial banks today. As I will illustrate in my statement, commercial banks have tremendous potential to offer a wide variety of financial services and to deliver those services efficiently at reduced cost to the customer. These include insurance, real estate, and securities activities.

The Treasury Department's bank holding company deregulation proposal, considered by this Committee in the last Congress, would allow bank holding companies to offer wider product lines in these areas. By placing the new activities in separately capitalized subsidiaries of the holding company, the Treasury proposal would protect depositors' funds from risk, while enabling bank holding companies to respond to the needs of customers for a wider range of financial products and services.

In response to increased customer demands, a more integrated market for financial services is evolving. The membership of today's panel is itself evidence of the blurring of lines among providers of financial services. Not many years ago, our firms' business lines were drawn clearly. Brokers sold stocks and bonds, insurers sold insurance, and bankers took deposits and made loans. Today we compete in a broad range of financial products and services. We seek customers on a worldwide basis and conduct the bulk of our business electronically.

Our rapidly changing market can be attributed to several factors. Technology is an important factor -- by transforming both the method and speed of financial transactions. Our antiquated regulatory system also plays a role -- by encouraging diversification for some firms while restricting others. But primarily, the current revolution in financial services is "market driven." Simply put, today's customers are demanding a quality and diversity of financial services beyond those offered in the past.

Each of the firms represented at this table is striving to meet those customer demands. Yet due to the varying laws and regulations governing each industry, our approach must often be roundabout. Hence we see money center banks acquiring South Dakota banks, and brokerage firms bidding for savings and loans. No moratorium, no matter how carefully worded, can reverse the trend or constrain all institutions equally. It only increases the inequities among institutions, and preserves the advantages of those institutions which gained expanded powers through acquisitions made prior to the moratorium.

Rather than encouraging Congress to act, a legislative moratorium can become an excuse for legislative delay. Once imposed, the pressure to act is relieved, while the temptation to extend the moratorium increases. Like Regulation Q, which was imposed as a "temporary" measure, a moratorium could linger on long past its expected life. What is needed is not a moratorium, but a serious review of the current laws governing financial service providers.

The Committee's inquiry, in my opinion, should ask how well do our current laws and restrictions, many enacted a half-century ago, serve today's users of financial services. The answer, I submit, is not very well.

Before offering specific examples of areas for reform, I believe it is fruitful to review the background of our changing marketplace, to assess the current ability of commercial banks to serve the market, and then to discuss the prospects for the future.

As a starting point, consider the typical family customer of Bank of America twenty years ago. Our bank would have then held the family's checking account, a loan on the family car, and possibly the home mortgage. If the family maintained ties with another financial institution, it would most likely be with a savings and loan that held the home mortgage. The family savings were in a passbook account, with us or the thrift. Interest rates were set by Regulation Q and inflation wasn't a worry. In this stable environment, competition among institutions was based on service not price. The branch location was often the deciding factor in choosing a bank.

For the commercial customer, the situation was similar. The typical medium-sized business had few requirements -- a checking account, an industrial mortgage and a working capital credit line.

By contrast, today's customers are far more demanding and more discriminating. Stanford Research Institute has estimated that today's average family has as many as twenty relationships with various financial institutions. Our typical family now probably has accounts at several banks, a thrift, and maybe a credit union. A brokerage account, an individual retirement account, and a money market fund are new additions. The family's first credit card may have been a BankAmericard, but now their cards sport names of banks 3,000 miles away.

Comparison shopping has become the rule, and the competitors are no longer limited to the neighborhood. One need only review the newspaper ads for the recently authorized money market deposit accounts to see that interest rate competition is here. The retired schoolteacher in Dubuque is now as interested in the money market rates as her pension fund's professional manager.

On the asset side, a similar revolution has occurred in loan instruments. The long term fixed rate mortgage has been replaced by a host of new variable rate loans. Families are also learning how to use their home equity to obtain substantial credit.

At the same time, customers are demanding more convenience and are welcoming the technology that provides it. Automated teller machines are becoming commonplace and are giving a new meaning to the term, "bankers' hours." The greater value customers place on their time has led to the "one-stop shop" for financial services -- savings, real estate, brokerage, and insurance at one location. The "one-stop shop" is a reality at Sears Roebuck -- and the goal of many banks.

Though less visible, just as great a revolution has occurred for commercial customers of banks. Putting idle cash to work is now the concern of every corporate treasurer, not just the Fortune 500. At Bank of America, we maintain an 800 number for medium-sized firms inquiring about rates on overnight CDs. In addition to cash management advice, banks now compete nationwide to provide the "middle market" with a broad range of services, including leasing, letters of credit, executive financial counseling, and overnight investment instruments.

Meeting the heightened demands of customers is possible in large part due to the technological developments of recent years. Electronic banking, both through automated tellers and, shortly, home-based units, is lowering transaction costs while increasing the convenience of banking. At the same time, shared nationwide networks of automated teller machines bring us closer to de facto interstate banking.

Technology is also improving the quality of banking services. Microcomputers and new software make financial planning practical for more than just the bank's wealthiest customers. The same technology makes cash management services practical for medium-sized corporations.

These technological advances are replacing our traditional concept of banks as brick-and-mortar outlets of financial services. An automated teller can be placed anywhere -- at a grocery store, an airport, or the plant gate. Computer generated letters solicit the customer's credit, insurance, and brokerage business. An electronic link allows the creation of the Cash Managment Account by joining a brokerage account in New York with a checking account in Ohio.

Most important, technology allows a wide variety of firms to offer financial services. Automated tellers aren't restricted to banks -- Sears, Safeway, and 7-Eleven are also planning deployment. Cross-selling of financial services -- from insurance to credit to retirement accounts -- is in the strategic plan of insurers, brokers, and bankers.

With so many new entrants into the financial marketplace, I am often asked whether commercial banks should be placed on the endangered species list. I believe banks will survive -- but only if they are given the ability to adapt to the changing environment. Darwinism is the rule in the financial world, and those institutions which best meet the needs of the marketplace will flourish. If the evolutionary process stops, either by lack of innovation or decree of regulation, banks may indeed go the way of the dinosaur.

I believe strongly that commercial banks are positioned well to meet the customer's increased demands. First, banks have in place extensive systems for the delivery of services -- both through branches and electronics. Second, banks' role in the payments system brings substantial expertise in the processing of financial information. And third, as primary providers of financial services, banks can provide related, "add-on" services at relatively low cost. One-stop shopping for financial services promises not only convenience, but substantial customer savings from the inherent economies of combining related services.

From our own bank, I can provide several examples of how we are moving ahead:

Our landmark acquisition of Charles Schwab, the nation's largest discount broker, was completed last year after lengthy regulatory consideration. The success of the Schwab organization itself is representative of the future direction of financial services. When fixed commissions were ended in 1975, only the largest customers were able to get substantial discounts on stock transactions. Charles Schwab saw an opportunity for the smaller investor, and acted upon it. By completing transactions more efficiently and eliminating the overhead of a traditional brokerage house, Schwab has passed on millions in commission savings to the small investor.

The services offered by Schwab are a natural fit with banking services. We have begun a pilot project of placing Schwab "kiosks" within our branches and are working on new products that combine traditional deposit services with access to a discount brokerage account. The end result will not only be convenience, but bringing the real dollar savings of discount brokerage to a much broader customer base.

Our MICROSTAR product illustrates how far the marriage between banking and electronics can go. With MICROSTAR, our business customers gain the equivalent of a teller window in their offices, with access to Bank of America's global network and treasury management expertise. This system brings state-of-the-art microcomputer technology into the office of the corporate treasurer.

These examples give a glimpse of how our bank is working to adapt to the new environment. With each new product offered by our non-bank competitors, our marketing staff with assistance of our planners and lawyers struggle to develop an equivalent bank product. But we are pushing at the limits of the law.

Increasingly, the needs of our customers are conflicting with the need to satisfy antiquated restrictions peculiar to banks. In an age of electronics, interstate restrictions on deposit-taking remain. At a time when our non-bank competitors can offer a full line of financial services, product restrictions of the Glass-Steagall Act and the Bank Holding Company Act limit what banks can offer. The result is a growing "regulatory gap" between banks and their non-bank competition.

The case for equitable treatment of banks has been made many times before this Committee. While I believe in the validity of the argument, I will not belabor the point. More important in my mind are the potential benefits to users of financial services -- benefits that result by allowing banks to become full participants in the financial marketplace.

For example, consider the buyer of a home. Purchasing a home under our current fragmented system involves an escrow company, title company, first and second mortgage lenders, real estate broker, homeowner's insurer, mortgage life insurer, and maybe more. Closing a deal on a house can be a lengthy, if not excruciating, process. Much of the information required by each vendor is identical and the paperwork repetitious. Allowing banks to package many of the services related to a home loan would certainly reduce the time required, and most likely reduce the cost.

Banks also have in place delivery systems that could provide a range of related insurance products at substantial customer savings. Much of the information required for meeting the customer's insurance needs is currently collected by banks. By reducing the overhead now required in the sales of insurance, these savings could be passed on to the consumer.

Next, consider a city government seeking funds for a major capital improvement. In California, restrictions placed in the state constitution by Proposition 13 have forced municipalities to rely primarily on revenue bonds. Although general obligation bond underwriting by banks is explicitly permitted under Glass-Steagall, revenue bond underwriting is not. This has more to do with the rarity of revenue bonds in the 1930's than any substantive concerns over bank risk. Municipalities have supported strongly bank competition in this market because they know even a difference of a few basis points in the underwriter's spread on a bond issue can translate into municipal savings in the millions.

Finally, consider a medium-sized firm in the Silicon Valley seeking capital for a major expansion. Bank of America provided early financing for such companies as Tandem and Rolm. We developed close banking relationships with these firms, and provided needed credit as they grew. Tapping the corporate debt and equity markets can be difficult and expensive for such middle market companies. When they do reach that stage, we may act as advisors and arrange a private placement. Yet the underwriting itself must be accomplished through a third party investment bank. Allowing commercial banks to engage in underwritings of corporate issues is a logical extension of financial services. Competition in these markets would be increased and the costs to the customer would be reduced.

The modern bank holding company structure would allow commercial banks to engage in these new powers without endangering the safety and soundness of depositors' funds. I support the concept, as put forward last year in the Treasury Department's deregulation proposal, of placing certain activities in separate subsidiaries of the holding company. In this way, insured funds are not put at risk, potential conflicts of interest are limited, and the subsidiary is placed on an equal regulatory footing with its competitors. For example, a securities subsidiary of a bank holding company would be subject to the same regulators as the current participants in that market.

These new powers for banks are not unprecedented. Overseas, where commercial banks face fewer restrictions, U.S. banks have a proven track record in providing non-lending, merchant banking services. Bank of America underwrites and distributes Eurobonds in the world market. Yet we are prohibited from conducting similar business in the United States. We believe that our domestic customers are entitled to the full level of service provided our international customers.

As I stated at the outset, meeting customer demands for more sophisticated and diverse financial services is the greatest challenge facing commercial banks today. These same customer demands are dictating the evolution of a more integrated market for financial services. The question before the Committee is not whether such an integrated market for financial services will occur, but whether banks will be allowed to participate fully in it.

If one remains in doubt about the future shape of the financial services industry, I encourage a trip to the Vallco Fashion Center in Cupertino, California. The Sears Roebuck store there features an Allstate Savings and Loan, Allstate Insurance, Dean Witter, and Coldwell Banker -- all across from housewares. The prospective homebuyer can get it all at once, plus his or her refrigerator and stove. Not far down the road is our Bank of America branch. We have the ability to provide our customers the same services (except the housewares) but the current regulatory system sends them to Sears. We want to compete for that customer's business and are convinced we can do it for less if only allowed.

The **CHAIRMAN**. Thank you, Mr. Armacost.

Next we have Mr. Caspersen, chairman of the board of Beneficial Corp.

STATEMENT OF FINN M. W. CASPERSEN, CHAIRMAN OF THE BOARD, BENEFICIAL CORP., PEAPACK, N.J.

Mr. **CASPERSEN**. Thank you, Mr. Chairman, members of the committee.

I, too, am pleased to be here before this committee, particularly with my able and rather aggressive competitor, sometimes a little too agressive for my taste, but I hope they feel the same about me.

Beneficial's business is that of providing the consumer with a full range of financial services and products. And we believe that any business enterprise which can provide such services in a manner not detrimental to society should be able to do so in a deregulated competitive environment.

My comments today will be brief and limited to one subject, the ownership of consumer banks and the alleged need for legislative change.

Simply, my view is that consumer banking should be regulated only to the extent necessary to protect the consumer and the economy. Present laws do accomplish this purpose quite effectively and there is no need to impose new limitations, nor to erect new barriers, even temporarily, through a moratorium on competition or entry into consumer banking business.

I am glad to have the opportunity to address you today, because for sometime we have heard both representatives of Government agencies and others comment on the implications of the changes in the financial services industry and the need for legislative action to close loopholes.

Somehow things that were earlier well thought out and specifically put into the law are now called loopholes to make sure banking and commerce are separate and distinct activities. Implicit in all of these comments is banking is a specialized industry and that participation in this specialized industry by entities other than those traditionally recognized as banking entities is unhealthy for the consumer, the economy and the country generally.

Also the implication is that Congress was mistaken or unaware of what it was doing when it took such actions as defining "bank" as it did in the Bank Holding Company Act, or approving section 333 of the Garn-St Germain Act.

The implication is the Federal Reserve let this slip through, when in fact it was the actual sponsor and drafter of the words, in question.

Quite frankly, I think the time has come to separate fact from fiction with respect to consumer banking issues and in this connection I would like to make a few observations.

MANY CONSUMER BANKS OWNED BY NONBANKING ENTITIES

Consumer banking, as distinguished from commercial banking, should not be considered a specialized industry with participation limited to traditinal banking institutions. The fact, quite simply, is that at the present time and for many, many years numerous consumer banks, whether we call them nonbank banks, industrial banks, thrift companies or by some other descriptive name, have been owned by nonbanking entities with strong capable structures and managements. These consumer banks have kept pace with rapid technological advances and have developed innovative and attractive products in recent years. These organizations are currently providing single source financial services to the consumer with no adverse consequences, and there simply is no demonstrated reason at this time to continue to reinforce the fiction that this aspect of banking should be limited to traditional banking entities.

Conversely, in fact, the focus of attention should instead be on the fact that the traditional banking entities—except for the brief respite afforded by legislation such as that authorizing money market instruments—are losing customers to other financial institutions because they have been considered special and consequently have been the subject of restrictive special statutes and regulations which have precluded maximum product development.

And I think we have heard just that from Mr. Armacost today.

Congress, in enacting the Bank Holding Company Act, did not inadvertently exclude the so-called nonbank bank from its converage, and this is not a loophole. The Senate report on 1970 amendments to the Bank Holding Company Act notes that the purpose of the act was to restrain undue concentration of commercial banking resources and to prevent possible abuses related to the control of commercial credit. On specific recommendation of the Federal Reserve Board, the Senate committee accordingly adopted a provision excluding institutions not engaged in the business of making commercial loans from the definition of bank. Senate Committee Report No. 1084—1970—91st Congress, 2d session, page 24. Not only is there no apparent reason to reverse that position, the creation or acquisition of such consumer banks seems to offer benefits to both the consumer and to the economy as a whole.

Consumer banks owned by nonfinancial institutions have not been involved in failures or problem situations, so far as I am aware, and indeed seem to be both sound and safe institutions. The asset base provided by consumer loans has been a sound, controllable, and incredibly well diversified base for many years, even in the worst economic conditions, and we have not seen the type of problems that result from the closely regulated commercial loan portfolios which have been responsible for some major bank problems in recent years. It would be ironic if the regulatory effort were concentrated on the best portion of the banks asset base, consumer loans.

Besides the stabililty of the asset base, the consumer banks are chartered by and subject to examination and supervision by various State and Federal agencies. They are also subject to State and Federal laws that control transactions between such institutions and their nonbanking affiliates, such as the clear and explicit provisions of section 23A of the Federal Reserve Act, which prohibit self-dealing or intercompany transactions which would place unnecessary risks on bank customers.

Accordingly, I would echo Mr. Robinson's comments. In Beneficial we regard the companies as real, and we can not move the assets back and forth at will, nor can we transcend the corporate entity.

The separate subsidiary concept if properly regulated and properly enforced, is a workable concept. The exclusion of Federally chartered or insured savings institutions from the provisions of the Bank Holding Company Act by section 333 of the Garn-St Germain Act was part of the effort to help those troubled institutions recover from overly restrictive regulations on the scope of their business. With the asset composition tests and other safeguards set forth in the applicable laws, rules and regulations, no reason was seen to preclude nonbanking companies from owning savings institutions free of Bank Holding Company Act restrictions. This, in my view, was a sensible, realistic and practical step forward that should not be reversed at this time on the basis of rather vague and unsubstantiated concerns about the separation of commerce and banking.

Having made these brief comments, I would like to make two additional and equally brief points:

One, if there are special problems relating to Glass-Steagall or other statutes unrelated to consumer banking, they should certainly be addressed. However, to take action, even temporarily, to prohibit the entry of new competitive entities into the consumer banking field, thus limiting the benefits to consumers and the economy that can be expected from that competition, is in my opinion unnecessary, unwarranted, and unproductive.

Two, with respect to the state of the financial services industry, the marketplace and consumer, two key factors, the marketplace and the consumer, should decide what services should be provided and where they want to receive them, rather than having those decisions made by the form of the institution providing the service or by artificial rules as to where the service can be provided.

In closing, let me simply say a consumer banking market with unlimited participation can most efficiently provide the diversity of services and products that will be demanded by the consumer. Consumer banking, unlike commercial banking, is driven by technological and market factors and should be allowed to progress. It may seem chaotic, it may seem disorderly, but in fact it is competitive and in fact it is providing the consumer with a new lower priced product in a more efficient manner.

Under existing rules that assure the safety and stability of depository institutions, affiliation with nonbank institutions can only add to the competitive potential by bringing capital, people, expertise, and new ideas into the developing financial services market.

Thank you very much.

[The complete statement follows:]

Statement by

Finn M. W. Caspersen

Chairman of the Board, Beneficial Corporation

Mr. Chairman, Members of the Senate Banking Committee, my name is Finn Caspersen, and I am Chairman of the Board and Chief Executive Officer of Beneficial Corporation, the nation's largest independent consumer finance company. Our business is that of providing the consumer with a full range of financial services and products and we believe that any business enterprise which can provide such services should be permitted to do so in a deregulated, competitive environment.

My comments today will be brief and limited to one subject: ownership of consumer banks and the need for legislative change. Very candidly, my view is that consumer banking should be regulated only to the extent necessary to protect the consumer and the economy. Present laws accomplish these purposes quite effectively and there is no need to impose new limitations on the ownership of such banks nor to erect barriers -- even temporarily through a moratorium -- to competition or entry into the consumer banking business.

I truly welcome the invitation and the opportunity to speak with you this morning because for some time now I have heard representatives of various government agencies and others comment on the implications of the changes in the financial services industry and the need for legislative action to close "loopholes" and make sure "banking" and "commerce" are separate and distinct activities. Implicit in all of these comments is that banking is a specialized industry and that participation in this specialized industry by entities other than those traditionally recognized as banking entities is unhealthy for the consumer, the economy and the country generally. Also, the implication is that Congress was mistaken or unaware of what it was doing when it took such actions as defining "bank," as it did in the Bank Holding Company Act, or approving section 333 of the Garn-St. Germain Act.

Quite frankly, I think the time has come to separate fact from fiction with respect to consumer banking issues and in this connection I would like to make a few observations.

Consumer banking, as distinguished from commercial banking, should not be considered a specialized industry with participation limited to traditional banking institutions. The fact, quite simply, is that at the present time and for many, many years numerous consumer banks -- whether we call them "non-bank" banks, industrial banks, thrift companies or by some other descriptive name -- have been owned by "non-banking" entities with strong capable management. These consumer banks have kept pace with rapid technological advances and have developed innovative and attractive products in recent years. These organizations are currently providing "single source" financial services to the consumer with no adverse consequences, and there simply is no reason at this time to continue to reinforce the fiction that this aspect of banking should be limited to traditional banking entities. Conversely, in fact, the focus of attention should instead be on the fact that the traditional banking entities -- except for the brief respite afforded by legislation such as that authorizing money market instruments -- are losing customers to other financial institutions because they have been considered "special" and consequently have been the subject of restrictive special statutes and regulations which have precluded maximum product development.

Congress, in enacting the Bank Holding Company Act, did not inadvertently exclude the so-called non-bank bank from its coverage, and this is not a loophole. The Senate Report on 1970 amendments to the Bank Holding Company Act notes that the purpose of the Act was to restrain undue concentration of commercial banking resources and to prevent possible abuses related to the control of commercial credit. On recommendation of the Federal Reserve Board, the Senate Committee accordingly adopted a provision excluding institutions not engaged in the business of making commercial loans from the definition of bank. (Senate Committee Report No. 1084 (1970), 91st Congress, 2d Session, page 24.) Not only is there no apparent reason to reverse that position, the creation or acquisition of such consumer banks seem to offer benefits to both the consumer and to the economy.

Consumer banks owned by non-financial institutions have not been involved in failures or problem situations, so far as I am aware, and indeed seem to be both sound and safe institutions. The asset base provided by consumer loans has been a sound and controllable base for many years, even in the worst economic conditions, and we have not seen the type of problems that result from commercial loan portfolios which have been responsible for some major bank problems in recent years. Besides the stability of the asset base, the consumer banks are chartered by and subject to examination and supervision by various state and federal agencies. They are also subject to state and federal laws that control transactions between such institutions and their non-banking affiliates, such as the clear and explicit provisions of section 23A of the Federal Reserve Act, which prohibit self-dealing or inter-company transactions which would place unnecessary risks on bank customers.

The exclusion of federally chartered or insured savings institutions from the provisions of the Bank Holding Company Act by section 333 of the Garn-St. Germain Act was part of the effort to help those troubled institutions recover from overly restrictive regulations on the scope of their business. With the asset composition tests and other safeguards set forth in the applicable laws, rules and regulations, no reason was seen to preclude non-banking companies from owning savings institutions free of Bank Holding Company Act restrictions. This, in my view, was a sensible, realistic and practical step forward that should not be reversed at this time on the basis of rather vague concerns about separation of commerce and banking.

Having made these brief comments, I would like to make two additional and equally brief points:

1. If there are special problems relating to Glass-Steagall or other statutes unrelated to consumer banking, they should certainly be addressed. However, to take action -- even temporarily -- to prohibit the entry of new competitive entities into the consumer banking field, thus limiting the benefits to consumers and the economy that can be expected from that competition, is in my opinion unnecessary, unwarranted and unproductive.

2. With respect to the state of the financial services industry, the market place and consumer should decide what services should be provided and where they want to receive them, rather than having those decisions made by the form of the institution providing the service or by artificial rules as to where the service can be provided.

In closing, let me simply say a consumer banking market with unlimited participation can most efficiently provide the diversity of services and products that will be demanded by the consumer. Under existing rules that assure the safety and stability of depository institutions, affiliation with non-bank institutions can only add to the competitive potential by bringing capital, people, expertise and new ideas into the developing financial services market.

Thank you very much, and I welcome your questions.

The **Chairman**. Thank you, Mr. Caspersen. Mr. Wriston, chairman, Citicorp.

STATEMENT OF WALTER B. WRISTON, CHAIRMAN, CITICORP, NEW YORK, N.Y.

Mr. **Wriston**. Mr. Chairman, I thank you for this opportunity to come before this committee with my friendly competitors in the financial industry.

You may recall I attempted to illustrate in October of 1981 to your committee the status of financial businesses by a chart which provoked some objections, because it used broad catagories rather than legalistic entities and tried to show in broad layman's strokes who is doing what with whom in financial services. The response this chart excited then convinced me of its effectiveness, and leads me to bring it back today, to show how conditions have progressed.

Here, now, is the progress since then.

WHO DOES WHAT

	COMMERCIAL BANK	AMERICAN EXPRESS	MERRILL LYNCH	DREYFUS	E.F. HUTTON	FIDELITY	PRUDENTIAL	AETNA	AMERICAN GENERAL	EQUITABLE LIFE	TRAVELERS	HOUSEHOLD	BENEFICIAL	SEARS	KROGER	J.C. PENNEY	GULF & WESTERN	LOEWS	GENERAL MOTORS	GREYHOUND	TRANSAMERICA	AVCO	PARKER PEN	DANA	AMERICAN CAN	ARMCO	NATIONAL STEEL	GENERAL ELECTRIC	WESTINGHOUSE	RCA	ITT	CONTROL DATA
Take Money/Pay Interest	●	●	●	●	●	●	●	●	●	●	●	●	●	●	◉	◉	●				●	◉	◉	●	◉		●	●		●		●
Check Writing	●	●	●	●	●	●	●	●	●	●	●	●	●	●	◉	◉	●			●	●	◉	◉	●	◉		●					
Loan	●	●	●	◉	●	◉	●	●	●	●	●	●	●	●		◉	●	●	●	●	●	●	◉	●	◉	●	●	●	●	●	●	●
Mortgage	●	●	●	◉			●	●	●	●	●	●	●	●		◉	●			◉	●	●		●	◉	●	●	●	●	●	●	●
Credit Card	●	●	●		◉	◉	●	◉			●	●	●	●		●	●					◉	◉	●			●			●		
Interstate Branches		●	●	●	●	●	●	●	●	●	●	●	●	●	◉	●	●	●	●	●	●	●	◉	●	◉	●	●	●	●	●	●	●
Money Market	◉	●	●	●	●	●	●	●	●	●	●			●	◉	◉	◉				●	◉	◉	◉			◉					
Securities	◉	●	●	●	●	●	●	●	●	◉	●			●	◉		◉	●			●											
Life Insurance		●	●	◉	●		●	●	●	●	●	●	●	●	◉	●	●	●			●	●	◉	●	◉	●		●		●	●	●
Property Insurance		●					●	●	●		●		●	●	◉	●	●	●	●	●	●	●		●		●		●		●	●	●
Casualty Insurance		●					●	●	●	●	●		●	●	◉	●	●	●	●	●	●	●		●		●		●		●	●	●
Mortgage Insurance								●	●		●		●	●			●	●		●	●	●		●	◉	●		●		●	●	●
Real Estate		◉	●				●	●	●	●	●			●		●	●	●		●	●	●		●			●		●			●
Cash Management Account	◉	●	●		◉	◉	●	◉		●	◉			●																		
Travel Agency/Service		●												●			●			●		●										
Car Rental												●	●	●			◉			●	●									●		
Data Processing (General)		●						◉												●		●					◉	●	●		●	●
Telecommunications	◉	●						◉														●						●	●	●	●	◉
Owns/Is Buying S & L	◉		◉	◉					◉			●		●							◉		◉	●			●					◉
Owns/Is Buying Bank	◉	◉	◉	◉		◉	◉	◉			◉	◉	◉			◉	●					◉	◉									◉

○ Financial Activity Since Fall 1981

The circled dollar marks indicate new entries since that time and we have grouped brokers, insurance companies, finance companies, retailers, and the like. But the information is the same as in 1981.

Let me begin by noting the new powers gained by commercial banks, and by expressing our appreciation to you, Mr. Chairman, for the Garn-St Germain Act, which finally got banks out of the 1930's and into the late 1970's. We also appreciate your continuing efforts to bring us right up into the 1980's, and you have our best wishes for success.

On the interstate branches line, we show that of all these companies, commercial banks alone may not branch nationally. This causes critics of this chart some anguish, which is appropriate, because it causes us great pain, too.

It simply means that Merrill Lynch may open an office, or Sears store, in any State, where customers may walk in and hand them money, to put in a money market fund, pay an insurance premium, or buy securities. They may market this convenience.

But although many States are passing laws to achieve this purpose, commercial banks still don't have the same freedom to open an office in any State where our customers may walk in the door and put money into our new money market funds, or make deposits. The offices we are allowed to open under the law are not bank branches, but special purpose subsidiaries.

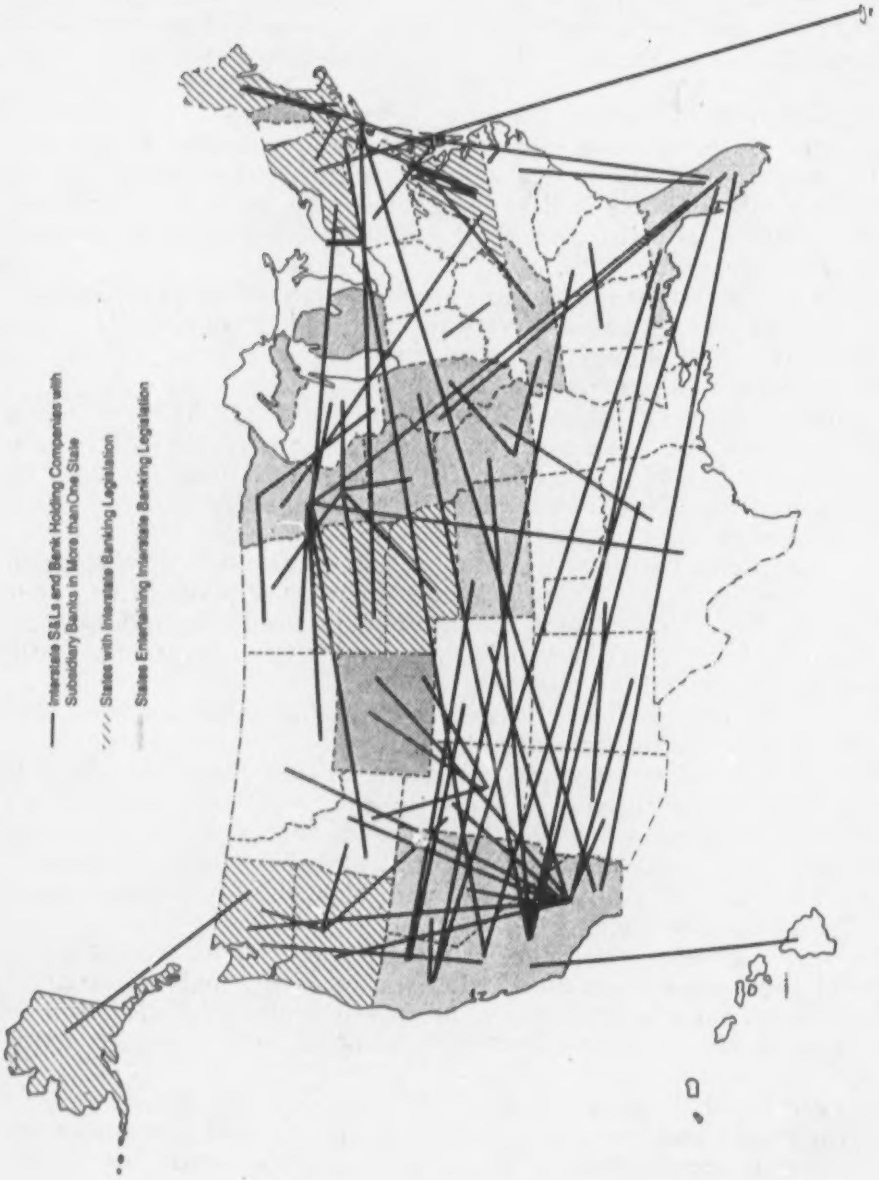
To us this handicap is central, and distinguishes us from our competitors in this important respect.

Perhaps the most important additions to this chart are the new lines: "owns or is buying a bank, or an S&L." As you see, all manner of companies are now buying commercial banks: Brokers, insurance companies, retailers, conglomerates. This means, of course, they get all the privileges of banks, notably deposit insurance, in addition to their original ones.

We have added a few more companies to the list. Kroger's, a chain of supermarkets in many States, now offers, next to the dried cereals, money market funds; by the frozen foods, securities, and on your way to the checkout line, life, property, and casualty insurance.

This chart, which does not pretend to be complete, conveys a certain irony with respect to a moratorium on so-called non-banks' acquiring or becoming banks. That horse is long since out of the barn.

Let me give you a geographic picture of the spread of interstate banking.


Interstate S&Ls and Bank Holding Companies with Subsidiary Banks in More thanOne State
States with Interstate Banking Legislation
States Entertaining Interstate Banking Legislation

The States on this map have already either passed or entertained interstate banking legislation. When we last met here, Mr. Chairman, only Maine, South Dakota, and Delaware had acted, and they only very recently. All the rest of these States have moved into or toward interstate banking in the past 20 months.

Thirteen States have actually passed one or another kind of interstate banking bill. They range from Alaska, which gives out-of-State banks full banking powers without requiring reciprocity, to Washington, which allows only deathbed acquisitions, to a whole spectrum of powers in between.

There are States that have entertained but not passed legislative initiatives on interstate banking. In some of these States, bills are actively pending. In others, the legislature adjourned without passing a bill, and studies are keeping the question alive until the next session.

These lines show commercial banks that have already gone interstate. As you see, because of grandfathering or other exceptions to the general rule, a few commercial banks have already created de facto interstate nets, even in States that haven't passed interstate banking laws.

Your recent legislation, Mr. Chairman, has made S&L's more closely resemble commercial banks.

As you can see from the map, they blanket the country. As the bank networks, so far, tend to be regional, the S&L lines stretch from coast to coast. And as you know, banks, among others, are buying S&L's.

Looking at the combinatinon of interstate banks and S&L's, we get a crystal clear picture of the effectiveness of our present ban on interstate banking.

The lines that once separated financial services are not only blurred, they have virtually disappeared, as innumerable companies are already engaged in marketing banking services nationwide. About 40 percent of the States have already either passed or begun to consider passing interstate banking bills of one sort or another. And the existing networks of interstate banks and liberated S&L's envelope the map. The dam has already broken, and it is too late to hold back the waters.

This, then, is the context in which we discuss a moratorium that would arrest a tendency toward interstate banking, and attempt to stop branching of interstate services by a broader spectrum of institutions.

I would submit that to place a moratorium on the environment that we have seen is patently unfair. To freeze this picture is in effect to allocate markets to those companies shrewd or lucky enough to be first off the mark. At the same time, a moratorium would deprive consumers of state-of-the-art financial services in areas where such progress has not yet arrived.

Is there something wrong with what is happening today, that we should halt it?

In my view, not at all. It is the natural and inevitable consequence of today's technological capabilities.

Nor do consumers object. Like yourselves, gentlemen, we depend on votes for our survival. Consumers vote with their dollars in the marketplace. The casting by American consumers of literally billions of such votes for new financial services made possible by the creeping deregulation of recent years, is a landslide that compels the attention of our political leaders. The public has voted and is voting in the marketplace for deregulation.

Rather than enact a moratorium, it is time for Congress to move forward. The Secretary of the Treasury has recommended legislation, which we support, which should serve as the focus for early congressional action.

Since these hearings coincide with the 50th anniversary of the Glass-Steagall Act, it's inevitable that this committee has heard nostalgic descriptions of life under that act's friendly protection.

I, too, am conscious of this anniversary of 1933, a year when the aviation industry proudly introduced the DC–1; when the Santa Fe Chief sped from Chicago to Los Angeles in 56 hours, and when the state-of-the-art teletype transmitted at the rate of 60 words a minute across thousands of miles of wires strung, pole by pole, across the United States.

We have just watched the space shuttle *Challenger,* successor to the DC–1, complete a week's mission in outer space, during which it launched yet two more communications satellites, each able to send data at the rate of nearly 1½ trillion bits per second nearly anywhere in the world, just as teletype and the mails carried transactions 50 years ago.

The world has clearly changed and we must all change with it, or suffer the fate of the DC–1 competing with the DC–9.

Mr. Chairman, Buckminster Fuller has alluded to the sort of person who believes that the course of evolution awaits his personal decision. You are clearly not such a person. You have demonstrated by your valliant efforts to bring consumers contemporary financial services that you recognize the forces at work today. We congratulate you for this and we commend your outlook to your colleagues and to our own.

The CHAIRMAN. Thank you, Mr. Wriston.

[The complete statement follows:]

Testimony by

Walter B. Wriston

Chairman, Citicorp

before the

Senate Banking Committee

June 27, 1983

* *

Mr. Chairman, I am Walter Wriston, Chairman of Citicorp, and I thank you for this opportunity to return, with my friendly competitors in the financial industry, to update the assessment we gave your committee in October 1981.

You may recall I attempted then to illustrate the status of financial businesses by a chart which provoked some objections, because it used broad categories rather than legalistic entities, and tried to show in broad layman's strokes who's doing what with whom in financial services.

The response this chart excited then convinced me of its effectiveness, and leads me to bring it back today, to show how conditions have progressed.

(CHART)

Here is the chart of October 1981. The blank spaces will accommodate new entries since that time, and we've grouped brokers, insurance companies, finance companies, retailers, and the like. But the information is the same as in 1981.

Here, now, is the progress since then.

(CHART OVERLAY)

Let me begin by noting the new powers gained by commercial banks, and by expressing our appreciation to you, Mr. Chairman, for the Garn-St. Germain bill, which finally got banks out of the 1930's, and into the late 1970's. We also appreciate your continuing efforts to bring us right up into the 1980's, and you have our best wishes for success.

On the "Interstate Branches" line, we show that of all these companies, commercial banks alone may not branch nationally. This causes critics of this chart some anguish, which is appropriate, because it causes us great pain too.

It means simply that Merrill Lynch may open an office, or Sears a store, in any state, where customers may walk in and hand them money, to put in a money market fund, pay an insurance premium, or buy securities. They may market this convenience.

But although many states are passing laws to achieve this purpose, commercial banks still don't have the same freedom to open an office in any state where our customers may walk in the door and put money into our new money market funds, or make deposits. The offices we are allowed to open under the law are not bank branches, but special purpose subsidiaries.

To us this handicap is central, and distinguishes us from our competitors in this important respect.

Perhaps the most important additions to this chart are the new lines: "owns or is buying a bank, or an S&L." As you see, all manner of companies are now buying commercial banks: brokers, insurance companies, retailers, conglomerates. This means, of course, they get all the privileges of banks, notably deposit insurance, in addition to their original ones.

We have added a few more companies to the list. Kroger's, a chain of supermarkets in many states, now offers, next to the dried cereals, money market funds; by the frozen foods, securities, and on your way to the check out line, life, property and casualty insurance.

This chart, which does not pretend to be complete, conveys a certain irony with respect to a moratorium on so-called non-banks´ acquiring or becoming banks. That horse is long since out of the barn.

Let me give you a geographic picture of the spread of interstate banking.

(MAP CHART)

The states in color on this map have already either passed or entertained interstate banking legislation.

When we last met here, Mr. Chairman, only Maine, South Dakota, and Delaware had acted, and they only very recently. All the rest of these states have moved into or toward interstate banking in the past 20 months.

The 13 states in gray have actually passed one or another kind of interstate banking bill. They range from Alaska, which gives out-of-state banks full banking powers without requiring reciprocity; to Washington, which allows only deathbed acquisitions; to a whole spectrum of powers in between.

Colored in blue, the color of hope, are states that have entertained but not passed legislative initiatives on interstate banking. In some of these states, bills are actively pending. In others, the legislature adjourned without passing a bill, and studies are keeping the question alive till the next session. The colors are spreading, not receding.

(BANK OVERLAY)

These lines show commercial banks that have already gone interstate. As you see, because of grandfathering or other exceptions to the general rule, a few commercial banks have already created de facto interstate nets, even in states that haven´t passed interstate banking laws.

Your recent legislation, Mr. Chairman, has made S&Ls more closely resemble commercial banks, so let´s remove this overlay and look at the interstate presence of our new bank-like S&Ls.

(S&L MAP)

As you see, they blanket the country. As the bank networks, so far, tend to be regional, the S&L lines stretch from coast to coast. And as you know, banks, among others, are buying S&Ls.

Looking at the combination of interstate banks and S&Ls . . .

(MAP WITH BOTH OVERLAYS)

. . . we get a crystal clear picture of the effectiveness of our present ban on interstate banking.

The lines that once separated financial services are not only blurred, they have virtually disappeared, as innumerable companies are already engaged in marketing banking services nationwide. About 40 percent of the states have already either passed or begun to consider passing interstate banking bills of one sort or another. And the existing networks of interstate banks and liberated S&Ls envelope the map. The dam has already broken, and it's too late to hold back the waters.

This, then, is the context in which we discuss a moratorium that would arrest a tendency toward interstate banking.

I would submit that to place a moratorium on the environment that we've seen is patently unfair. To freeze this picture is in effect to allocate markets to those companies shrewd or lucky enough to be first off the mark. At the same time, a moratorium would deprive consumers of state-of-the-art financial services in areas where such progress has not yet arrived.

Is there something wrong with what is happening today, that we should halt it?

In my view, not at all. It's the natural and inevitable consequence of today's technological capabilities.

Nor do consumers object. Like yourselves, gentlemen, we depend on votes for our survival. Consumers vote with their dollars in the marketplace. The casting by American consumers of literally billions of such votes for new financial services made possible by the creeping deregulation of recent years, is a landslide that compels the attention of our political leaders. The public has voted and is voting in the marketplace for deregulation.

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The world has clearly changed and we must all change with it, or suffer the fate of the DC-1 competing with the DC-9.

Mr. Chairman, Buckminster Fuller has alluded to the sort of person who believes that the course of evolution awaits his personal decision. You are clearly not such a person. You have demonstrated by your valiant efforts to bring consumers contemporary financial services that you recognize the forces at work today. We congratulate you for this, and we commend your outlook to your colleagues and to our own.

The CHAIRMAN. Mr. Roger E. Birk, chairman of the board of Merrill Lynch.

STATEMENT OF ROGER E. BIRK, CHAIRMAN OF THE BOARD, MERRILL LYNCH & CO., INC, NEW YORK, N.Y.

[The complete statement of Mr. Birk follows:]

STATEMENT OF

ROGER E BIRK, CHAIRMAN

MERRILL LYNCH & CO., INC.

Introduction

When I was here in October of 1981 we spent a considerable amount of time talking about change in the financial services industry. During the intervening 20 months the pace of that change has accelerated. I would like to spend my time this morning talking about Merrill Lynch's view of the impact of that change on the consumers of financial services, and on the United States financial system. The bottom line is that we believe the change has been beneficial and that the deregulatory thrust that this Committee adopted in reporting the Garn-St. Germain Act should be continued.

Merrill Lynch & Co.

As you know Merrill Lynch and Company is the holding company for a diverse, worldwide financial services organization. Through subsidiaries we provide services to domestic and foreign individuals, corporations, institutions, and governments.

Altogether, Merrill Lynch & Company's activities are conducted through nearly 1,000 offices worldwide in which over 40,000 individuals are employed or associated.

Objectives

Mr. Chairman, our various programs and activities demonstrate Merrill Lynch's concern for, and commitment to, three basic goals: (1) the enhancement of capital formation; (2) the preservation of customer choice and diversity among providers of financial services; and (3) the safety of customers financial assets and our nation's financial system. In our view, the same goals should underly this Committee's deregulation efforts.

Evolution of the Financial Services Industry -- The Proposed Moratorium

That deregulation thrust has led to a number of notable events since our last panel discussion. These include:

- BankAmerica acquired a New York Stock Exchange member firm, Chase filed an application to acquire a brokerage firm, and Security Pacific both acquired a brokerage firm and formed its own. And countless other banks began offering securities services through joint ventures with brokerage companies.

- Dreyfus and J.W. Seligman acquired national banks and J.C. Penney announced plans to acquire one.

- Prudential Bache and Merrill Lynch filed to acquire or to form state-chartered non-member banks.

- Savings and loan associations entered the stock brokerage business, either through INVEST, or through their own separate brokerage affiliates.

- Dreyfus, Thomson McKinnon, and Merrill Lynch sought approval to acquire savings and loan associations, and Citicorp acquired one.

- Citicorp and BankAmerica indicated their intention to enter the insurance business in states where this is permissible.

- The FDIC proposed allowing state chartered non-member banks to underwrite corporate securities.

- Deposit taking institutions were authorized to pay market rates of interest on certain deposit liabilities, and have attracted over $365 billion into those accounts. Money market mutual fund balances fell 26% to $170 billion from $230 billion.

These events are a cause of concern to some. This concern has been expressed in calls for a moratorium on further change for a period of time. I believe that a moratorium is the wrong action for Congress to take at this time for a number of important reasons.

First, consumers of financial services are benefiting from the deregulatory trend now underway. They are receiving innovative products in innovative ways, all designed to increase their choices and improve their financial condition.

Second, a moratorium inevitably will be unfair. While we are unsure of what it would proscribe, any moratorium gives an advantage to those who have already entered a line of business by keeping out others who wish to compete. There appears to be no reason to allow such an advantage when we are unaware of any abuses that have occured to date.
Third, a moratorium will hinder this Committee's efforts to establish an appropriate legislative framework for the newly emerging financial services industry. Our national experience has shown the necessity for American enterprises to adapt to meet changing world patterns. This Committee has undertaken a much needed review of the evolving financial services industry, for which the Committee is to be commended. But the industry is still in an early stage of evolution, which makes analysis and decision making very difficult. When the evolution of the industry is further advanced, needed changes in the legislative pattern will become clearer. A moratorium would hinder such evolution and would make it more difficult for this Committee to discern needed legislative changes and to take legislative action.

Needless to say, since we belive that Congress should not enact a moratorium, we feel even stronger that such a moratorium should not come about because of administrative action on the part of government bureaus. If there is to be a change in the policy found in the statutes, that change must come from Congress and not be imposed by administrative action.

If a moratorium is not the answer, then what is?

I submit that there is nothing wrong with the way events have gone up to now, and are likely to go over the next year or two. Events are being shaped by market forces - the economy, new technology, the demands of an increasingly sophisticated consumer and increased foreign competition. It is my belief that the country is well served by the competition which has developed and the consumer has benefited enormously by having access to a wider array of services at more competitive prices than ever before.

So long as regulators do not make decisions which serve to restrain competition in the financial services industry, and so long as the regulators interpret current laws in a manner which is neutral to all participants and would-be entrants to an industry segment, then I believe that competition will bring even greater benefits to consumers in the form of more innovation and greater efficiency in financial services. If the regulators will simply let competition produce these benefits, Congress can monitor the results, continue its review and, if necessary, make whatever modifications and add whatever safeguards are appropriate.

At the point that your Committee decides that legislation is necessary, we believe that certain concepts being advocated by the Treasury Department are worthwhile. We endorse the concept of having different financial services performed by separate subsidiaries within a holding company structure, and of having those subsidiaries regulated on a functional basis with each function being regulated by the same regulator. Securities activities should be regulated by the SEC, banking activities by the appropriate bank regulator, insurance activities by the appropriate insurance regulator, and so forth. We believe that such a regulatory scheme will be fairest to competitors and provide maximum protection to consumers.

Conclusion

To summarize, Mr. Chairman, we are for competition and the consumer benefits it generates. And we believe that competitors should be regulated functionally.

The evolution in the financial services industry to date has been driven by market forces and has provided benefits to the consumer in the form of innovative products and services delivered in innovative ways at a variety of price levels. The most efficient and least harmful way of determining the optimum shape of the financial services industry of the future is to let market forces play themselves out. As this occurs Congress can observe, and can take action if necessary. Trying to halt the deregulatory drive at this time would stifle competition and the innovative benefits it has fostered.

The Chairman. Thank you, Mr. Birk.

Mr. Robert A. Beck, chief executive officer and chairman, Prudential Insurance Co.

STATEMENT OF ROBERT A. BECK, CHIEF EXECUTIVE OFFICER AND CHAIRMAN, PRUDENTIAL INSURANCE CO. OF AMERICA, CHICAGO, ILL

Mr. Beck. Thank you very much, Mr. Chairman. I, too, am grateful to be here before this committee to express my views on the issue of where things are going in the financial services business and especially so with so many old friends and hopefully friendly competitors.

[The complete statement follows:]

STATEMENT OF ROBERT A. BECK, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, THE PRUDENTIAL INSURANCE COMPANY OF AMERICA, BEFORE THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, UNITED STATES SENATE, ON JUNE 27, 1983

PRESS OFFICE READING COPY

Mr. Chairman and Members of the Committee: I am Robert Beck, Chairman and Chief Executive Officer of the Prudential Insurance Company of America. I'm grateful for the opportunity to appear before this committee to express my views on issues of great concern to all of us in the financial community.

If anything, the pace of change has intensified since some of us appeared before this committee less than two years ago. I believe now, as I did at that time, that most of the changes that have taken place in the financial community are in the best interest of the public. I am in favor of freer competition. I believe it will force all segments of the financial community to be more efficient and more responsive to the needs of our customers.

But I also believe that deregulation must proceed very deliberately if we are to avoid major dislocations and effects that nobody has anticipated. I expressed some concern about this in my earlier appearance before this committee, and events since then have increased my concern.

There is a great deal of uncertainty right now in the financial community and in the marketplace. Much of that uncertainty is the result of what has amounted to a piecemeal approach in eliminating long-standing regulations without fully understanding the implications of doing so.

No one can say right now with any certainty which institutions are going to be permitted in the future to engage in which financial activities. As long as this is the case, some financial services organizations -- my own company included -- are moving aggressively to gain the powers they would like to have or believe they must have to protect or enlarge their share of the market.

I believe we're at a point where Congress must take a look at the total picture and ask a number of fundamental questions -- then move to put into place comprehensive legislation that will settle the issues involved and eliminate this uncertainty.

The most striking development of the past two years has been the way in which the competitive position of commercial banks and savings institutions has been strengthened. In rapid succession, we have seen:

- Tax-exempt All-Savers certificates.
- Legislation giving savings and loan associations most of the lending powers of commercial banks.
- Federally-insured money-market deposit accounts, with no ceiling on interest rates.

- Super-NOW checking accounts, with no ceiling on interest rates.
- The dismantling of controls on deposit interest rates.
- Rulings that are permitting commercial banks and thrift institutions to expand into discount brokerage.
- More and more states lowering the barriers to interstate banking.
- And, most recently, state legislation intended to open the door for banks to engage in all aspects of insurance.

As a result of all of these changes, banks have seen their deposits swell, and thrift institutions have gained new luster.

The removal of more and more restrictions by bank regulators, the aggressive actions taken by leading banks to broaden their powers, and the aggressiveness of other financial services organizations in pursuit of banking powers have had an influence on the actions of my own company -- as I am sure they have had an influence on other financial organizations. At Prudential we are no more willing than anyone else to suddenly find ourselves in a position where we are unable to meet our competitors on equal footing.

Most financial intermediaries are finding it necessary to ask themselves what businesses they want to be in to accomplish their own objectives. At Prudential our goal is to be a quality provider of a broad range of financial products and services -- and, like it or not, we find ourselves being pulled into banking to protect our current business. That's why we made an offer for a small bank in Georgia.

We want to convert it into a nonbank that qualifies for federal insurance guarantees because of the value of those guarantees for our money-market products.

During the past few years there has been a lot of discussion about the need to create a level playing- field for all competitors. But I question whether any of us really know how to achieve a level playing field or understand what that entails.

In my opinion, a thorough and comprehensive examination of the issues is overdue. I am not presuming that we can answer all of the pertinent questions at one time, but let's take a hard look at what we already know are key questions:

1. Level Playing-Field -- What is a level playing-field? What does it mean? How can it be achieved? How can we be sure the removal of regulatory restrictions will not produce reactions by institutions within the various segments of the financial services industry that are prompted solely by a perceived need to protect their customer relationships and their share of the market?

2. The Regulatory Function -- New technology has changed the world since many of our present laws and regulations were adopted. Financial institutions are now able to offer totally new combinations of services and a much broader and more flexible range of products. What role should regulation play today? What should be the mission of the regulatory agencies? What does the public

need protection from? The task force headed by Vice President Bush is examining these questions, but I am sure the Congress will want to obtain the views of state regulators as well.

3. FDIC coverage -- Why should some financial intermediaries have FDIC coverage and not others? Has FDIC coverage been extended beyond its original purpose? Why should my company have to acquire a nonbank in order to get FDIC coverage for our money-market mutual funds so we can compete on equal footing with banks? What should FDIC coverage really be used for?

4. Concentration of Economic Power -- What kinds of dangers are present in deregulation? Do we know whether deregulation will result in better services for customers? How can tie-in sales be avoided? Can there be adequate safeguards to prevent abuses and insure that the will of Congress is heeded?

In short, I believe most of the changes taking place are clearly in the best interests of the public. I am not opposed to deregulation, but I am concerned about the removal of regulatory restrictions on a piecemeal basis without an adequate understanding of the implications involved. I believe we are at a point where Congress should step back and try to see where we are going to make sure the solutions it devises are not worse than the problems we face. We need a very careful and comprehensive study of the issues.

The ultimate objective ought to be to provide a sound and fair basis for the delivery of the full range of financial services -- one that allows so-called financial supermarkets and smaller, specialized firms to co-exist, with both having fair and equal opportunities to compete for business.

Thank you, Mr. Chairman, for giving me this opportunity to express my views on these vital matters.

The CHAIRMAN. Thank you, Mr. Beck.

Next, Edward R. Telling, chairman of the board and chief executive officer of Sears, Roebuck & Co.

STATEMENT OF EDWARD R. TELLING, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, SEARS, ROEBUCK & CO., CHICAGO, ILL.

[The complete statement follows:]

STATEMENT OF EDWARD R. TELLING

CHAIRMAN AND CHIEF EXECUTIVE OFFICER: SEARS, ROEBUCK AND CO.

before the

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

June 27, 1983

Mr. Chairman and members of the committee.

My colleagues and I at Sears are greatly complimented by your invitation to me to appear before this important Committee and in such august company.

After almost six years as Chairman of Sears, Roebuck and Co., I had begun to think--perhaps even to hope--that I would complete my stewardship without an occasion to burden a committee of the Senate with my views. I only hope that they may be of some small value to you.

I am advised by Mr. Aires, Mrs. Edwards and others upon whom Sears relies here in Washington that your preference is for a very brief statement at this time, supplemented by a more extended written submission which we have filed for the record.

My comments at this time will be very general and, I hope, well within your time constraints.

All of us here today recognize the importance of the issues which face this Committee. Some of us, however, may have slightly different perceptions of those issues.

Your letter to me, Mr. Chairman, suggested that the central issue is the current status and the future direction of the financial services industry. I suggest, most respectfully, that the central issue should be what kind of an environment do we need to encourage the people of America to save and to invest.

In my view, this Committee's decision as to what ought to be done or ought to remain undone about the structure of the financial industry should be a function of that goal -- increased savings and investment -- rather than a concern for competing interests in the marketplace or jurisdiction within the government.

Let me focus for a moment on the issue of savings.

Economists may argue as to whether the savings rate is a cause or an effect of an otherwise poor economic climate. But all agree that more savings today would improve our living standard tomorrow.

Our savings rate for many years was too low by any standard.

Nothing the Congress and the Reagan Administration do with respect to economic policy will be more important than the steps already taken to improve the environment for personal savings.

For the first time in many years inflation rates are waning and all Americans--big savers and small savers alike--can begin to feel confident that investment and saving can be a better deal than spending.

What the Administration and the Congress have done so far to bring this about merits every commendation.

What remains to be done--or for you to decide not to do--is substantial.

There can be no better way to encourage savings and investment in this nation--in fact there are few better ways to achieve almost any important national objective--than to encourage the American business community to demonstrate its initiative, its resourcefulness, its imagination and its tenacity through spirited competition.

It has been the policy of the Federal Government since the Sherman Act was adopted to encourage honest competition in the marketplace--not because it is expedient for the competitors--but because it is in the best interests of the consumer.

A hallmark of bona fide competition is innovation and because Merrill Lynch, Citicorp, Beneficial, American Express, Bank of America, Prudential, Kemper, Sears, Roebuck and many others have been competitive and innovative, the marketplace for those who wish to save or to invest is far more attractive than it has ever been.

The diversity of financial service products has increased and access to those products has improved.

Driven by competition, the cost of services will be lowered, marketplace efficiency improved and technology accelerated.

These trends are good for the economy and good for the consumer. They should not be dampened because of uncertainty about what the Congress is going to do.

We hear, however, discussions of a "moratorium" or of delays beyond the term of the 98th Congress.

I fully appreciate the difficulty of resolving some of the controversies before you. I appreciate that there may be a sense of frustration when the only apparent legislative option may seem to be to ratify changes which have already taken place. I am not insensitive to the political convenience of postponing some of the decisions which the Congress and the Administration will have to make.

But the convenience of postponing business decisions is simply not available to those of us who are before you today or to our colleagues throughout the business community.

Any extended moratorium or unreasonable delay by the Congress in coming to grips with its responsibility would be injudicious; any notion that we can "stand pat" for a year or so would be greatly misplaced. It would not change the trend toward de facto deregulation in financial services. It would merely provoke the development of new aberrations and compel the business community--large institutions and small ones alike--to make decisions based upon our best guess as to what the rules of the game will be a few years out.

I have almost exhausted my time, so let me touch briefly on a few specifics that are treated in a little more detail in my written submission:

First, we agree with a recommendation Secretary Regan made to you a couple of months ago that the authority of thrift institutions to offer a wider range of services should be increased on an appropriate schedule.

Second, we would like to say to this Committee and to our friends in the banking community who wish to offer their customers a broader range of financial services, that if they plan to do so on the same basis as the rest of us, under the jurisdiction of state insurance authorities, the anti-trust laws and the Securities Exchange Commission, and through unsubsidized subsidiaries that have no special advantages over the rest of us in raising capital, then as far as Sears is concerned they are welcome to pull up a chair and get in the game.

Third, Sears associates itself with those who believe that the time has come to repeal, or at least revise, those statutes which provide that depository institutions, uniquely among all business enterprises in this nation, should be restricted to a single state. For reasons, set out in more detail in my written submission, I believe that fears for the welfare of smaller community-based banks--if this were to happen--are not well founded.

Finally, in reference to housing, we are pleased by projections which indicate the recovery will be strong and sustained. This trend is particularly encouraging to Sears, because our lines of business are related in one way or another to the housing industry. These lines include homeowners insurance, residential brokerage, mortgage banking, and private mortgage guaranty insurance. Indeed, Sears has recently announced intentions to broaden our participation in mortgage finance as a private distributor of mortgage backed securities.

Mr. Chairman, for myself and for all of my associates in the management of Sears, I thank you and your colleagues on this Committee for your courtesy and for your attention.

I conclude where I began: I urge once more that the touchstone of your efforts be the continuing need in this nation for improved opportunities and an ever-improved environment for investment and for savings.

It has been suggested occasionally that this is a strange notion to be advanced by a retailer who might appear to have a somewhat greater stake in consumption.

We at Sears think otherwise. We think the best interests of all Americans--including retailers--will be served by a productive economy and a diminishing rate of inflation.

The basis of all Sears plans and all Sears goals is the fact that we have great confidence in the strength of this country--in the good judgment and capacity of its citizens to make prudent decisions in a competitive marketplace--and, of course, in the will of this Congress to give them the opportunity to do so.

Thank you.

SUBMISSION OF EDWARD R. TELLING

CHAIRMAN AND CHIEF EXECUTIVE OFFICER: SEARS, ROEBUCK AND CO.

in connection with testimony before the

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

June 27, 1983

Mr. Chairman and members of the Committee.

My direct testimony this morning will recommend that it be a priority of this Committee and of this Congress to continue to encourage increases in the level of private savings and investment.

I will also express my view that neither a so-called "moratorium" nor an extended delay by the Congress in resolving--one way or another--the financial service issues now before it would be in the public interest.

It is the purpose of this paper to set out the views of Sears, Roebuck and Co. and its related companies on some of those issues.

I

By way of background, Sears, Roebuck and Co. originated out of an enterprise that began in 1886 when Richard Warren Sears, a freight agent in North Redwood, Minnesota took over an unaccepted consignment of watches and discovered that he had a knack for selling things.

Out of this effort grew a mail order business which expanded rapidly in the first quarter of this century and then a retail business which originated between the wars and expanded dramatically in the 1950's and the 1960's.

Today, the principal businesses of the company are:

Sears Merchandise Group consists of merchandising, credit and international operations:

Merchandising distributes broad lines of merchandise and services in the United States.

Credit initiates and maintains the 30 million customer credit accounts generated by Merchandising.

International conducts retail merchandise and credit operations in Central and South America, Mexico and Puerto Rico and in Canada through Simpsons-Sears Limited (an equity affiliate).

Allstate Insurance Group provides property-liability insurance and life-health insurance. The group also includes mortgage guaranty insurance activities.

Coldwell Banker Real Estate Group invests in, develops, manages, and acts as a broker in real estate and provides various real estate services, which include mortgage finance activities.

Dean Witter Financial Services Group engages in securities brokerage and principal trading activity, domestic and overseas investment banking, mutual fund and money management, savings and loan and related services, and consumer finance activities.

Sears World Trade, Inc., a new global services company, will assist businesses and governments in the exporting and importing of products, technology and management services and will provide related consulting services.

The Company has approximately 350,000 shareholders and 400,000 employees. Its revenues in 1982 were just over $30 billion.

II

In the field of financial services, Sears has long had an important presence.

Allstate Insurance Company, the nation's second largest property-liability carrier, recently celebrated its 50th anniversary and the Allstate Life Insurance Company its 25th.

Sears, Roebuck Acceptance Corp. in Delaware and Allstate Savings and Loan of California have been part of our corporate family since the 1950's

We have been extending some form of credit to our merchandise customers since 1911.

When it became our perception that other financial systems were not fully meeting consumer needs, we decided to take a broader position in financial services.

This led to our acquisitions in 1981 of Coldwell Banker and Dean Witter Reynolds and to our developing program to market their services and those of Allstate Insurance independently of one another, but in a common facility within Sears retail stores.

It is our belief that the options in financial services, thus presented, are remarkably well understood by the small saver as well as the sophisticated investor. We see this understanding growing as the government shifts its policy to encourage savings and investment, in preference to consumption, so as to fill the nation's need for capital formation.

III

Let me turn to a few specifics.

We noted with interest Secretary Regan's testimony of a couple of months ago. On the whole, it was most constructive.

We agree with him that the authority of thrift institutions to offer a wider range of services should be increased on an appropriate schedule.

It is important, in my judgment, to the nation's long-standing commitment to increased family home ownership, and to the housing industry which must serve that need, that thrift institutions retain their character as a significant provider of home loans.

Their ability to do so, however, will require at least some increase in their authority to make consumer and commercial loans at competitive rates.

I appreciate that to some extent these matters are now within the authority of the Federal Home Loan Bank Board and other regulative bodies. I hope that they will continue to move forward towards further deregulation.

IV

You have been urged with some intensity to expand the authority of banks to engage in additional non-bank financial services.

Sears, despite occasional suggestions to the contrary, is not a bank in any proper sense of the term, and we appreciate that there are aspects of this issue to which we bring a limited expertise.

Our only comment, therefore, is to note that in the general merchandise retail business, where our taproots are, we are used to the dynamics of competition.

No retailer has ever argued that the marketplace belongs to the one who got there first.

We think the marketplace belongs to those who can deliver to the consumer the best product at the best price.

We seek no special advantages and we do not urge that our friends in the banking community be burdened with any special disadvantages, not firmly rooted in the most compelling public policy.

If those in the banking community, who wish to offer their customers a broader range of financial services, plan to do so on the same basis as the rest of us, under the jurisdiction of state insurance authorities, the anti-trust laws and the Securities Exchange Commission, and through unsubsidized subsidiaries that have no special advantages over the rest of us in raising capital, then as far as Sears is concerned they are welcome to pull up a chair and get in the game.

V

Let me comment briefly on the McFadden Act, the Douglas amendment and those provisions of state and Federal law which are rooted in the anachronistic assumption that depository institutions, uniquely among all business enterprises in this nation, should be restricted to a single state. Whatever justification there may have been for such laws in our past, there is clearly no basis for them in this era of rapid communication and transportation, electronic transfer of funds and a vibrant interconnected national economy.

There have, of course, been changes in these restrictions recently: further evidence of their obsolesence. Sears associates itself with those who favor a complete repeal of geographic restrictions. To the extent that this is simply not politically practicable, we urge the Congress to take whatever steps it can in that direction.

Perhaps I can offer a word to those who are gravely concerned that this step would, as one member of the House of Representatives put it, result in a "system of far-flung and diverse activities of financial giants, in which our smaller community-based institutions would be swept away."

Some 37 years experience in the retail business, with a pretty good sized company that does business in every one of our 50 states enables me to tell you authoritively that that just isn't what happens. There isn't a Sears store in the country that doesn't have in its market several locally owned, community-based, well-run retail competitors who push us hard every day of the week.

The most significant development of the 70's in retailing was the growth and strength of so many new specialty stores who found a niche, exploited it skillfully and did very well indeed.

In the airlines business, deregulation has meant more competitors, not fewer.

The beneficiary in all these cases has been the consumer--who has had a broadened choice of products and services at more and more attractive prices.

Those of us, large or small, who fail to meet our customer's expectations, or who misjudge what they are, will fall by the wayside.

That is as it should be.

I recognize, of course, that an entirely proper concern for depositors in banks and thrift institutions requires that the "right to fail" implicit in the capacity to compete must be modified in the case of those institutions.

Nothing in that fact, however, warrants or requires geographic limitations on doing business.

VI

Let me comment briefly on a related subject that is important to Sears and, I believe within the scope of this Committee's interest.

In the area of housing and mortgage finance, favorable developments appear to be in store for the economy and the consumer. As of the end of the first quarter of this year, total housing starts were at nearly twice the level of a year ago, and the highest level in three and a half years. New housing permits are also up sharply, with the first quarter 1983 level of 1.5 million units being more than 80 percent higher than a year ago. This recovery is not only due to a pent-up demand for housing--which has existed for nearly three years--but also resulted from reduced inflation and mortgage interest rates. In addition, the financial position of consumers has improved, with a reduction of consumer installment debt burdens and with reduced inflation bolstering the purchasing power of take-home pay.

This trend is particularly encouraging to Sears, because many of our lines of business are related in one way or another to the housing industry. These lines include homeowners insurance, residential brokerage, mortgage banking, private mortgage guaranty insurance and sales of merchandise related to housing.

We believe that the critical issue in the housing area is affordable mortgage financing. Because of our concern about this issue, we are actively seeking ways to develop sources of such financing. As an example of this, Sears recently announced its intention to become a private distributor of mortgage backed securities. Our arrangements will include mortgage origination, purchasing portfolios of mortgages from other originators, and sales of securities backed by these mortgages. Sears plans to market the securities to the investing public, including institutional and individual investors, through the Dean Witter Reynolds organization.

These arrangements will create new sources of mortgage capital, which will help to give the consumer greater access to mortgage funds at an affordable price. That, of course, is the most logical result of new entrants in any business. An obvious but important point about this program is that its benefit will be available to consumers without any use of federal credit programs. Instead, this is a private business venture and will most likely be developed by other companies as well.

VII Conclusion

Mr. Chairman, for myself and for all of my associates in the management of Sears and its subsidiaries, I thank you and your colleagues on this Committee for your courtesy and for your attention. I thank you too, while the opportunity presents itself, for the courtesy all of you and your staffs have extended to Mr. Aires and to other officers and executives of Sears companies who have come into your office from time to time.

I conclude where I began: I urge once more that the touchstone of your efforts be the continuing need in this nation for improved opportunities and an ever-improved environment for investment and for savings.

It has been suggested occasionally that this is a strange notion to be advanced by a retailer who might appear to have a somewhat greater stake in consumption.

We at Sears think otherwise. We think the best interests of all Americans--including retailers--will be served by a productive economy and a diminishing rate of inflation.

The bases of all our plans and all our goals--for Sears and its affiliates--is the fact that we have great confidence in the strength of this country--in the good judgment and the capacity of its citizens to make prudent decisions in a competitive marketplace--and, of course, in the will of this Congress to give them the opportunity to do so.

The CHAIRMAN. Thank you, Mr. Telling, and may I first thank you for a speech you gave a couple years ago. I carried it around with me until it was absolutely dog-eared and I had to get a new copy because during all of the discussions from our oversight hearings in 1981 and then through the hearing process on S. 1720, there were a lot of people in this country, particularly a lot of independent banks and small institutions, who did not believe that the revolution was occurring, the changes were going on.

So I don't even need the copy with me. I can quote your speech about how there may not be 15,000 banks left in the country in the future and that you would offer deposits and dispersion of funds in every Sears store and every office of Coldwell Bankers and Dean Witter and that was extremely healthy and helpful to me in carrying that dog-eared speech around, and when I had to get up in front of a group and I would say, "Well, fine, if you want Sears to take over all of our banking institutions, just sit pat and let's have no changes whatsoever." I'm not being facetious at all. That speech was very helpful in convincing some people that had their heads stuck in the sand and in the 1930's who didn't want to face any change.

Let me turn first of all to the issue of McFadden and interstate banking. As I view the marketplace, interstate banking is already here. We certainly have interstate loan generation offices. Citicorp is in my State in the form of finance companies, not in the form of a commercial bank. We have interestate trust operations. We have grandfathered institutions in the form of First Interstate in my area of the country operating in 11 Western States, and we have Northwest Bank Corp. in the Midwest. We have also had numerous mergers of troubled institutions of different types of institutions across State lines and we certainly now have the technological changes that create the money machines in Safeway Stores and wherever for transfer of funds throughout the country and many institutions, some of them represented here, that have no geographical restrictions whatsoever in where they offer their financial services.

So it seems to me, whether we like it or not, interstate banking is here and the issue is how we address that. I would say, as I've said many times before, that there certainly are not sufficient votes within the Congress now—there is still a general attitude in opposition to interstate banking and branching on the idea that we will have a great concentration of financial services in 10 or 12 or 15 large institutions in this country.

So my first question would be to Mr. Armacost. Certainly BankAmerica is the largest bank in California and one of the largest in the world, and it appears to me in looking at California and as I've had to deal with California in my legislation. I know of no State that has such a diversity of financial institutions. Now certainly you have branches all over California literally blanketing the State. Do you have competition in California or have you squeezed everybody else out?

COMPETITION IN CALIFORNIA

Mr. **Armacost**. Would that be true, Mr. Chairman, I think the fears that you expressed in terms of undue concentration of power have been overstated as a premise to interstate banking, and I think the example of California is as good an example as one could find to see the future. I would put forward that I think California is as competitive an environment for financial services as you could find in this country. I think my colleagues at the table would probably support me in that.

The whole microcosm of the marketplace is represented there—large chain banks operating on a statewide basis, regional banks within the state competing either on a product or geographic basis, the full panoply of international banks and near-banks or non-bank institutions supplying the same services, investment banks, and so forth. I find most thriving and doing well, honing their edges in terms of their competitive efficiencies and effectiveness with regard to the competition that's afforded there, and I think, having grown up in that environment, we have few concerns that the public will not be served exceptionally well in terms of expanding interstate banking.

The most effective competitors, surprisingly enough, in California tend to be the smaller, well-focused, independent banks that have taken the largest share gains in recent years, which I think is to say that local institutions across this country have continued to be effective and compete efficiently. There is a barrier in terms of those long-term relationships that have been instilled in those communities for long, long periods of time that will not be undone just because BankAmerica or Citicorp or Sears or someone else plants the flag in that community and says, "We're here. Come do business with us." So I think California is a good positive example.

The **Chairman**. You not only have a large number of independent institutions, both commercial banks and brokerage houses and savings and loans, but haven't you had large increases over the last few years in the number of new institutions, small ones coming into existence in California, despite that competition?

Mr. **Armacost**. We have that now, Mr. Chairman, in larger numbers now than at any time in our history.

COMPETITION IN NEW YORK

The **Chairman**. Mr. Wriston, you have told me before that your experience in upstate New York was not exactly what you would liked it to have been in competing with some of the small independent institutions that had that local flavor and had been loaning to people's fathers, grandfathers, and so on.

Could you tell the panel how you feel about that kind of competition and, as large as you are, whether you were able to drive them out?

Mr. **Wriston**. Mr. Chairman, in the simplest terms, they handed us our head. We went up there to compete and we found what you have long known, that a small bank in a small town has built relationships with family and friends and the community and a political apparatus that are so strong that it would be very, very difficult indeed to dislodge those. We had a hearing before your committee and Mr. Small, who was in charge of that operation, testified before Mr. Proxmire. It took us something like 6 or 9 years to break even. So I would endorse what Mr. Armacost said and also mention, if my memory serves me, that more new banks were chartered in California in 1982 than at any time in history. So competition is alive and well among the small independent banks.

The CHAIRMAN. Well, the perception is that obviously if we make any changes in McFadden that we do concentrate power in a few large institutions and that's why I was aware of the situation both in New York and in California and appreciate your responses because it has not been my experience that the large institutions have been able to drive out the small ones. As a matter of fact, there are plenty of examples of where the smaller institutions have been the most fiercely competitive and have caused the large institutions to close branches where they were not able to compete. That doesn't mean I endorse suddenly repealing McFadden all at once. I do not. But I certainly hope we could come to some conclusion that we're not going to have 10 or 12 large institutions control the financial services industry of this country. I think there are just too many innovative minds and too many capable people in this country to allow that to happen.

It's also been my experience that sometimes the very large do not continue to have that entrepreneurial spirit that some of the small institutions do.

OPINIONS OF FUNCTIONAL REGULATION

Gentlemen, throughout these hearings this year we've heard a great deal of talk about functional regulation rather than the way we do it at this time. Mr. Caspersen, what's your opinion of all this talk about functional regulation? Is that the way we should be going?

Mr. CASPERSEN. I believe the key concept is the product that you produce and not the historical accident that created the corporation or the institution, and to that extent, functional regulation is entirely appropriate.

Institutional regulation, though, has worked in large respect, and I don't think we should quickly discard that, but we can meld over into functional very easily without any abrupt changes. So I think it should be looked at, considered, and changes should be addressed toward bringing it to functional, but not overly promptly.

The CHAIRMAN. Mr. Birk, what is your opinion of functional regulation?

Mr. BIRK. I support it, Mr. Chairman. I think we can demonstrate it can work. I think it's probably the most logical approach to the proposition that we have before us, the diversity of financial institutions. I can see it work at Merrill Lynch. We own a small insurance company in Seattle, Wash., which is, well regulated by the State insurance commissioner. All our securities activities are regulated by the appropriate securities regulators, and there are many of those, but I have found no substantive reason to say that functional regulation cannot work or that it would not be efficient.

The CHAIRMAN. Senator Proxmire.

POSITION ON MORATORIUM

Senator **Proxmire**. Mr. Beck, as far as I know you're the only member of the panel that hasn't taken a position on the moratorium. Maybe you did and I missed it. On page 2 you say:

> I believe we are at a point where Congress must take a look at the total picture and ask a number of fundamental questions and then move to put into place comprehensive legislation that will settle the issues involved and eliminate this uncertainty.

Then on page 5 you say:

> I'm concerned about the removal of regulatory restrictions on a piecemeal basis without an adequate understanding of the implications involved. I believe we're at a point where Congress should step back and try to see where we are going to make sure the solutions it devises are not worse than the problems we face. We need a very careful and comprehensive study of the issues.

That's put very well. It is precisely what those of us who favor a moratorium are trying to do.

What is your position on the moratorium?

Mr. **Beck**. Senator, I believe you were out at the time I made my verbal comment and at that time I indicated that I was in favor of a moratorium provided that during that period of time covered by the moratorium these kinds of questions which I have spoken about and others have spoken about were really addressed rather than having a moratorium which just allowed time to pass by without people being sufficiently concerned to bring it to a head.

Senator **Proxmire**. Well, I appreciate that very much and I think the latter implication is very true, too, that we have to act and if we do pass a moratorium we have to act during that period to consider legislation so we don't just, as you say, let time pass.

Mr. Wriston, I referred earlier to the fact that Citicorp has purchased a State chartered bank in South Dakota shortly after the South Dakota law went into effect permitting State chartered banks to operate insurance companies outside of South Dakota.

What plans do you have for entering the insurance business outside the State of South Dakota?

Mr. **Wriston**. Well, Senator, as you know, the Federal Reserve Board in 1971 issued a regulation which said that they would not take a view on what services State banks provided and that the Congress of the United States has no national policy about insurance. They have never looked at that. That is entirely regulated by the 50 States. There is no national chartering. So that the business in which we will engage, providing that we are permitted to do so, will be basically that insurance that is related to individuals and their homes and life, about the same kind of coverage that is given by the insurance companies owned by people at this table, except for casualty, which we have no interest in going into at this point in time.

Senator **Proxmire**. Perhaps you can help me, Mr. Wriston. I'm confused. It was my understanding that Garn-St Germain did seem to provide a limitation on the banks getting into the insurance business. Did I misunderstand that?

Mr. **Wriston**. I understand that the restrictions in those laws are on bank holding company activities, but not on the banks themselves.

IMPACT OF ACQUISITIONS OF S&L'S BY SECURITIES FIRMS

Senator **Proxmire**. Mr. Birk, the head of the U.S. League of Savings Institutions has written to the committee expressing the league's concern over the acquisition of savings and loans by securities firms. He says, and now I quote:

> We suspect that the dominant motive of the securities firms in seeking a savings institution subsidiary would be essentially to secure a device to provide FSLIC insurance for the investment products offered to the parent companies' Wall Street customers.

Do you think that's an accurate assessment? And if not, how would you characterize the motives of your firm in seeking to acquire a savings and loan association?

Mr. **Birk**. Well, I don't think that's a totally accurate characterization. We provide some of that service now by offering insured CD's of other institutions to our customers. It would give us the capability of doing that kind of business or offering a variety of products and services to satisfy what would seem to be our customers' needs. It would also give us a funding capability for mortgage or housing activities in which we are engaged.

In addition, it would give us the capability, if we chose to use it, to perhaps become more efficient in various processing activities in which we are currently engaged.

So I wouldn't restrict it to offering products that have FDIC insurance and say that's our only goal.

REPEAL OF GLASS-STEAGALL ACT

Senator **Proxmire**. Let me ask you for a show of hands if I can get it from this very distinguished panel. Some have argued that the Glass-Steagall Act has served its purposes and it should now be repealed. How many members of the panel would favor outright repeal of the Glass-Steagall Act?

I take it there were three responses—Mr. Armacost, Mr. Wriston, and Mr. Telling. Let me ask Mr. Caspersen, if the act is not to be repealed, what should be the criteria, in your judgment, Mr. Caspersen, for determining the separation between commercial banking and securities activities?

Mr. **Caspersen**. I didn't raise my hand because I think an outright repeal means completely breaking down all the barriers. I think the criteria has to be that the safety of the institution and the depositor and the ability to control the country's economy that lies in the Federal Reserve. I think those factors can be satisfied by a detailed act reviewing that and in effect repealing the blanket prohibitions that are there now.

Senator **Proxmire**. Thank you, Mr. Chairman.

The **Chairman**. Senator Hecht.

Senator **Hecht**. Thank you, Mr. Chairman.

Mr. Beck, you brought out in your testimony what I feel is one of the key points in this and you alluded to the FDIC coverage and more or less the way Sherlock Holmes would say to Dr. Watson, "There's more than meets the eye."

NO NEED FOR 100 PERCENT FDIC COVERAGE ON DEPOSITS

Now you are acquiring a bank only for that purpose, to get FDIC coverage. Not long ago, Mr. Isaac from the FDIC appeared before us and brought out that he does not feel in the future we should have 100 percent FDIC coverage for deposits.

How do you feel about that?

Mr. BECK. Well, let me comment first, Senator, that it wasn't the only reason for seeking this nonbank but it was the primary reason. We would hope we would also like to have insured CD's. I should comment, however, as an insurance company, that somehow the term insurance being attached to any of our products does make us feel better as a marketing organization.

I would share the view expressed by many that further definition or redefinition of FDIC coverage is badly over-needed. It's been something that has not yet taken place and I agree that there should not be full coverage.

Senator HECHT. Mr. Wriston, for years banks have used this as a number one vehicle to get deposits. How do you feel about that?

Mr. WRISTON. Well, I believe that the FDIC insurance, which is often referred to as government insurance although all the costs are paid by the banks and all the premiums are assessed against the banks, has been one of the finest things that the Congress has done.

I think that it was originally limited to a small amount of deposits for individuals. Over the years, as the premiums paid by the commercial banking system have continued to accumulate, that ceiling has been raised until there is a feeling, which I don't believe is statutory, that all deposits are insured.

If my memory serves me, they're insured only up to $100,000. I think that's an appropriate level and I think that amounts above that put a discipline to be desired on the marketplace.

Senator HECHT. Other people the last 2 months have testified they feel that that is an abnormally high figures, so I'm very happy that you are on record saying that you support the $100,000 figure.

Mr. Armacost, how do you feel about that?

Mr. ARMACOST. I would feel the same way. I think the move announced by the FDIC toward incentive-based regulation is a positive step. I think you can't define all elements of risk out of the marketplace, although I must say I am in a sense in mild confusion. We have heard that money market funds grew from zero to well over $200 billion, that they were not deposits, but were securities and therefore needed no insurance. Suddenly they now need insurance. So I think we need redefining of money market funds as deposits, and then we have to consider the question of reserves and other forms of attendant concerns that surround deposit instruments. But I think the FDIC has been a good creation and has been a great contribution to the marketplace. I think its aspects should be broadened to the limits.

Senator HECHT. Two questions. What do you mean by reserves for money market funds that you advocate?

Mr. ARMACOST. Well, if I understand some of the comments this morning, the attraction to buying a bank is to push the activities of money market funds through a bank vehicle in order to attract insurance coverage for those funds. We would call those deposits. On those deposits we pay reserves to the Federal Reserve System and maintain them on a zero or below market interest rate basis. Therefore, I think there needs to be some definition, perhaps of what kind of funds those are.

Senator **Hecht**. Do you feel the money market funds have had an unfair advantage the last few years?

Mr. **Armacost**. Absolutely, but I think those have now been mitigated by and large.

Senator **Hecht**. How do you feel about the $100,000 coverage of FDIC?

Mr. **Armacost**. I think it's fine at that level. I'd hate to see it risen.

Senator **Hecht**. Would you like to see it dropped?

Mr. **Armacost**. It wouldn't hurt to see it dropped. I would not advocate that. I think the market is used to it; it serves a purpose at this level; I think it's fine there.

Senator **Hecht**. OK. Mr. Birk, as far as the FDIC coverage again, what would that do to your—how can you react to that in the securities business with your money market funds?

Mr. **Birk**. Well, they are totally separate. Money market funds are just that. They are registered under the 1940 act. They're owned by the shareholders, regulated by the SEC. Deposits are just that. Deposits can be used for a variety of purposes with the institution regulated by the appropriate government regulator. And that's why reserves are required. So they're two different entities basically, and while it's been said here that money market funds may have had an advantage earlier, to the extent that advantage was there it was because banks did not have the ability to pay competitive rates. It had nothing to do with any other major factor. But either the FDIC insurance, through a non-member bank, or FSLIC insurance through a savings and loan, would cover only deposits and would be handled in a separate subsidiary.

I might add with respect to the question of whether Glass-Steagall should be repealed, if I may, because we were asked for a show of hands, the reason I did not raise my hand is because the thrust of my testimony basically is that what is going on is good and that one can observe over time whether or not problems will result rather than to attempt to design some sort of premature solution over a short period of time.

I think we have to face the basic question of Glass-Steagall which is corporate underwriting and insured deposits at some point. We have that now in Sears which in essence has a savings and loan with insured deposits and is in fact an underwriter. So it's not a question of what might come about. What I'm saying is that I think that by letting these things develop and observing them we will probably come out with a better result than if we try to reach a conclusion at this point because nobody knows for sure it seems to me whether Glass-Steagall should be removed or not or whether the ultimate effect would be good or bad.

Senator **Hecht**. Thank you, Mr. Chairman.

The **Chairman**. Senator Riegle.

Senator **Riegle**. Thank you, Mr. Chairman.

As you all know, last year we worked very hard and finally came up with what is called the Garn-St Germain legislation but we were able to get it done because there was a bona fide emergency that developed with balance sheet insufficiencies of the S&L's and a lot of other things, and as you know, having been through that struggle, each of you in your own way, it's very difficult to make these changes in law because you've got interest groups sort of set against one another and if the line is drawn further one way than another it takes away or threatens to take away the other fellow's business and so forth.

So it's very difficult to take and to rewrite these laws, in part because of the nature of our process where everybody bears in on it and as often as not paralyzes the legislative process rather than speed it up or bring it to conclusion. And very often, when we finally do get a response, it's kind of a common denominator where we do as little as possible in order not to take and disadvantage anybody to any great extent to somebody else's gain.

With that in mind, several of you have called for additional study. I mean, we've been studying this here at some length on the Senate side in the Banking Committee under the Chairman's leadership. We've been in it any number of times. But I notice, for example, Mr. Beck, you say in your statement that we need a very careful and comprehensive study of the issues. Mr. Armacost, you say on page 3 of your statement that what is needed is a serious review of the current laws governing the financial service providers. And, in addition, there are a lot of other voices who say more study, more thought—and you're part of a study process here today.

ORGANIZE A COMMISSION TO STUDY BANKING PROBLEMS

What would you feel, all of you, about the idea of trying to resolve this issue with some kind of a commission approach similar to what we saw with the Social Security problem? It's not a perfect device. There aren't perfect devices around here and you may have strong feelings one way or the other, but what if a group were empaneled with the President and Congress working together on it to report back on a very timely basis, not something that stretches over a long period of time, but with a precise mandate to come in with formal recommendations as to what, if any, changes in law or structure ought to be made to perhaps balance in a different way the way the sectors sort of fit together and relate to one another in terms of meeting financial services in this country. Whether that was done in a 4-month period or a 5-month period, in any case, to try to resolve the issue and to try to do it as much as possible outside the paralysis of sort of interest groups colliding head-on.

Before you respond, Mr. Beck, I'd ask you to do that first because you made the point most directly. There does seem to be strong feeling on the part of some for a moratorium. If, in fact, we were to see a moratorium as the alternative or as a gathering development, might an independently empowered group, presumably with the members of Congress even as part of it, who were required to come forward with specific recommendations—might this be a way to sort of perhaps respond in a form other than the moratorium because some are pushing that very hard. So, if one doesn't believe in that, it might be that one has to then find some other alternative that seems to be workable that perhaps would be thought of as acceptable.

Mr. Beck, do you want to start and then I'd like to hear from the others.

Mr. **Beck**. Yes, Senator. Having served on that commission with Senator Heinz, maybe it is appropriate for me to begin.

I thought during the year that our commission met—I think everyone on that commission swung back and forth, both on pros and cons, about whether this was going to lead in any kind of positive direction. At one time I thought it was very bad that we had people from Congress on the commission and so did they, incidentally. I think as time developed it probably was mandatory in order to accomplish what was accomplished through that commission. I believe it was also mandatory that the President and the majority leader and the Chairman of the House, the Speaker, be on it, because that was the only way the legislation would move.

I think that Social Security Commission has the potential for being the prototype for examination of several issues, provided all of those elements were built into it. I would believe, too, that, as Senator Garn has indicated, there's a great deal of information around and so the term study perhaps is not as appropriate as decision making in sifting through all of the alternative choices and coming down, one way or the other, on several of them and then having that opened for discussion and examination.

I believe very strongly in the value of the deregulation process that we have been going through, but I don't like the process as it causes action and reaction by the different financial intermediaries in order to try and maintain the markets that they have begun with. Does that respond to your question?

Senator **Riegle**. That's helpful. Who would like to go next?

Mr. **Wriston**. Senator, my memory of American history is that only two commissions have resulted in legislation. These two are the Social Security and the MX Missile.

As far as the financial services business is concerned, we have Dr. Elliot's 5-foot shelf of commission reports; the Commission on Money and Banking in 1961, for example; and no action was taken. There was the Hunt Commission and so forth. So that it seems to me that all of the elements are in place for a knowledge base and we know what is going on.

Second, I would second my colleague Mr. Birk's point that the marketplace out there is supplying to the consumer what he or she wants and I see no one that is being damaged and I see an enormous number of people, like 200 million Americans, who are being advantaged.

So the idea of let's stop the world, I want to get off, does not appeal.

A third reason is that in my State of New York, 40 percent of all the loans to commercial enterprises are made by foreign banks. We live in a global marketplace. So the idea of studying one more time—we've chewed that gum and there's really no flavor left in that. I think it's sort of time to make a decision.

Senator RIEGLE. I might just say because maybe I didn't make myself clear, but the thought that I was asking you to respond to—and I'm not prepared at the moment to propose this—is not another study. I agree with you. We've got stacks of studies. What we need to do is make some decisions. But the question is how you arrange the decision machinery in a way so you get a decision so that months don't pass because I have a feeling that there are businesses that Citicorp is not in today that they would like to be in. I got that distinct impression and the question is. Is that feasible? Is there a way to get there? It may well be that the only way that's going to be done is in some kind of a comprehensive revision. It's very hard to get one of those barring an absolute catastrophe facing us. I'm just concerned that the inertia is the strongest force of all unless you find some way to break the inertia. So I'm not asking for a study group. I want to make sure we understand each other. I'm talking about a group empaneled with the right kind of power figures to make specific recommendations and put the issue right square up on the table so it can be dealt with and presumably resolved.

Mr. WRISTON. May I make just a 1-second response?

Senator RIEGLE. Yes, please.

Mr. WRISTON. We have in the United States a dual banking system, and as I testified, there are 13 States that have already passed laws and 40 percent of all States are now doing it. The insurance business has no Federal policy. They are entirely regulated by the States, if I understand it correctly, and I believe that the constitution says that the powers not enumerated to the Congress are reserved for the States and to the people.

FINANCIAL MARKETPLACE OPERATING VERY GOOD FOR THE CONSUMER

So what I am suggesting to you is the process of the marketplace, both politically and financially, is operating. As Mr. Birk testified, the consumer is getting his insurance at the Cupertino store at Sears, where, incidentally, their first securities trade was, I believe, about 2,700,000, if I remember the paper correctly. It's probably inflated.

Mr. TELLING. You're highly informed, Walter. I will have to check.

Mr. WRISTON. I happen to have it with me. So that the market is working and I don't see any possible benefit to the consumer if what we're talking about is stopped. Is the person in Detroit being advantaged? He's been advantaged by the Garn-St Germain bill, which permitted him to get a fair return on his savings account. That was passed I believe partially because our innovative friends in the securities business invented the money market fund, and suddenly people knew the difference between 15 percent and 5 percent. That genie is never going to go back in the bottle. So I believe that the marketplace is very good for the consumer. The securities business knocked us out of the box, but this Congress reacted and permitted us to pay a fair price and that's the way the process works. I think it works beautifully.

Senator RIEGLE. Would anybody else like to comment?

Mr. **Caspersen**. I would like to echo Mr. Wriston's thoughts. I think the market process is working and it seems to me that as long as there's no harm that it should be allowed to continue to work. Those that are being harmed are perhaps those in the private sector who have special interests who are not conveying a product at a competitive price and they are worrying whether Congress should act to prevent competition from going into those activities. There's been no demonstration that the consumer or the depositor is suffering any damage and, further, as Senator Proxmire mentioned, I don't think that there's any demonstration that there's a concentration of financial resources here. If you take this industry which those of us at the table represent, I think you will find a smaller percentage of resources as opposed to the entire industry than almost any other major industry service or industrial in the United States.

Taking Beneficial, for instance, we're among the largest providers of consumer loans in this country and yet our total market share is well under 3 percent. That's competition and I think you can say much the same for any of the other gentlemen here. We're not concentrated. We are probably the most diversified and unconcentrated industry in the country.

Mr. **Armacost**. Senator, I'd like to be on the record associated with promarket forces as well. My comments earlier, as I say, were not meant to imply I favor more study. It was only meant to imply that any review must be done in terms of how well existing legislation serves the marketplace, and I was willing to stipulate not very well indeed.

My concern with a commission is only from experience. Unless you also empower it to take action, you're still up against the special interest forces that have mitigated against anything being accomplished in the ongoing process and, therefore, I would think it's time to get on with it. We've got miles of testimony, and I would let the market sanction process go on.

Senator **Riegle**. Mr. Birk.

Mr. **Birk**. Senator, as I mentioned earlier. I have supported publicly the call for a commission certainly going back sometime. I agree with Mr. Wriston that the record with respect to commissions is not outstanding, but it could be a mechanism to cause decisions I suppose. However, I would like to suggest if there were a commission, either presidential or congressional, that we do not have a moratorium in the meantime. It would probably cause a little additional pressure on the commission. I would object to a commission if it weren't restricted in numbers if it weren't given specific deadlines, if it didn't function full-time, and a number of other things. The testimony is in and it's a question of the decision making process, but people should not be prevented from competing in the meantime while such a commission were considering the matter.

Senator **Riegle**. Mr. Telling.

Mr. **Telling**. I think everything has been said.

I raised my hand on Glass-Steagall to express exactly how I feel about this regulation: that is it was essential when it came about and it came about to protect the consumer, as most regulation starts, but as time passed and that same regulation started to proect an industry at the expense of the consumer, as always happens whether it's a 5.5 percent passbook account or Glass-Steagall or airline fares or brokerage fees. I firmly believe the marketplace has spoken, speaks every day, hundreds of millions of Americans, and Congress should listen.

The CHAIRMAN. Senator Gorton.

Senator GORTON. Mr. Armacost, it seems to me that Mr. Wriston's chart was to a certain extent inapplicable to you as you have now almost acquired the largest banking firm in the State of Washington and, in a sense, along with a few other similar acquisitions, are about to prove either the merits or the demerits of interstate banking.

INTERSTATE BANKING ENCOURAGED

Could you outline the ways in which your goals for your operation as the owners of the Seattle First National Bank will benefit the people of the State which that bank serves and thus perhaps provide an example as to why interstate banking should be more widely permitted?

Mr. ARMACOST. Senator, that's probably a unique opportunity. In normal circumstances, I'm not sure we would get that opportunity, but in these circumstances what we think we can afford is, in the first instance, capital strength underneath that institution which I think it needs to survive. There are synergies, if that's not an overused term, to lower the cost of both institutions in effect and bring those to bear for the benefit of consumers in both of those States. I think it provides a balance in terms of the growth goals for both that institution and our own that can be helpful with respect to where it intends to go in the future. I think it gives us and Seafirst an access to resources which we need to export our growth opportunities in the short term. We'll have to wait and see how that plays out in the marketplace and, as Mr. Wriston said, the marketplace has votes. That will be determined by whether Washington, in combination with us, has benefitted or not. I suspect it will.

Senator GORTON. How many of those advantages would obtain if interstate banking were much freer than it is now, if you were able to acquire banks without regard to their financial condition?

Mr. ARMACOST. One would hope that all of those advantages would be present in a merger. Otherwise, I cannot see management desiring to spend capital to involve themselves in it.

Senator GORTON. One question for Mr. Birk if I may. Your testimony had an intriguing and rather precise advocacy of a concept of functional regulation for different entities within a bank holding company, that is securities in the Securities and Exchange Commission and the like.

Given the importance of overall bank stability to our economy and obviously that importance increases as their functions increase, do you see any need for a single regulatory entity at the Federal level with some kind of oversight over the entire structure of bank holding companies?

Mr. BIRK. I recall some mention of that subject I think with respect to the Treasury proposal at one point. I would really leave that question to the Bush committee, quite honestly. I don't personally see the need for that, if in fact there is good functional regulation, and I really think there can be. I think the regulation of broker-dealers, for example, by the primary regulators, whethers it's the New York Stock Exchange or anybody else, would not give any evidence of the fact that that's a problem, that capital has been removed to the detriment of the broker-dealer, for example, if they're owned by large, broad entities. So that I would be a little cautious about having a so-called super regulator supervisors, so to speak, because I think the capabilities of banks would be carefully delineated and can be regulated and the bank holding company function and the bank holding company activities I think would be properly handled by the appropriate regulators.

Senator GORTON. In other words, regulation by function rather than entity?

Mr. BIRK. Yes, sir.

Senator GORTON. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Mr. Chairman, the hour is late and I will be very brief.

Mr. Beck, I was very impressed with your thoughtful statement, as I was by the statements of your colleagues here. You were the only semidiscordant note on the question of whether or not we should support a moratorium.

PROCEED WITH CAUTION ON DEREGULATION

I was intrigued by a comment in your prepared statement in which you say that deregulation must proceed very deliberately if we are to avoid major dislocations and effects that "nobody has anticipated", that's a concern of mine, unpleasant consequences that are unanticipated. You go forward in your statement and say that your concern has increased even further since your earlier appearance before this committee, events since your earlier appearance have increased that concern.

Would you be more specific, sir; and tell us what some of those events are that have increased your concern and perhaps pushed you in the direction of caution?

Mr. BECK. Well, I had in 1981 testified then that I believed that we needed to be deliberate about our deregulation, though conceptually I very much support the principle. And, incidentally, I should comment that on that show of hands about Glass-Steagall, it was either a yea or a nay, and as a result that influenced my vote. I think Glass-Steagall does need substantial change.

Senator SASSER. Let me say, sir, that many of us in the Senate wish we could vote maybe on a lot of legislation.

Mr. BECK. Very fair, sir. To provide one illustration, as the banks got into the equivalent of money market funds and were able to sell these funds in the marketplace very effectively by the way and a very good product for the public, that compelled us to reexamine our position about banks and nonbanks. Our long-term strategic plan did not call for getting into the banking business or the nonbanking business or the consumer banking business. I really don't like to be compelled to move in another direction only because of regulatory changes that otherwise would not force us to go in that kind of direction.

As other changes and implications are felt and understood, I believe that will compel us to go that way too.

I really don't want to be a bank, but if the banks are going to have all the powers we have, I believe we will have to be a bank and seek that authority. Does that respond to your question?

Senator SASSER. Yes; thank you, Mr. Chairman.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, I want to follow up Jim Sasser's question to Bob Beck because he just made a rather interesting statement, which is that you don't want to be a bank but you're afraid you will have to be one. Why?

Mr. BECK. If the banks get all the powers in other fields that we have, with some advantage, then we'll have to become a bank just in order to compete.

Senator HEINZ. Well, you can do a lot of things that banks really can't do. What is there that a bank inherently has that you would have to have in order to compete?

Mr. BECK. Well, FDIC coverage is one, but that's been already commented on.

Senator HEINZ. And that's the biggest; is it?

Mr. BECK. No, no. I think that's a major force, at least for some of the products and services that we want to provide. Above all, I guess the one that I'm most concerned about is the tie-in sale implications and its impact on the level playing field between banks, insurance companies, and other issuing entities. I do believe in functional regulation and I support the direction that testimony has been given in the Treasury statement about the kind of functional regulation affecting each of the different kinds of fields in our financial services area. But I'd like to be sure that that functional regulation is such that the opportunity for tie-in sales and the use of economic power doesn't compel the packaging of products in a way that gives the banks an unfair advantage.

If it turns out that that's the only way for us to stay in business and use that same kind of tie-in sale, then we would feel compelled to believe that examination of expansion into the banking business would be necessary for us.

Senator HEINZ. When you use the term "tie-in" sale, you're talking about linking any kind of lending activity to other associated services?

Mr. BECK. Yes; requiring the other services if you're going to be able to get a loan, or a combination of a home loan to a package.

Senator HEINZ. Or making an offer that can't be refused?

Mr. BECK. Yes.

Mr. WRISTON. Isn't that illegal?

Mr. BECK. I thought it was. I'd like to see it further defined so that the ranges of illegality were better understood.

Senator HEINZ. Well, let me ask you, based on Mr. Wriston's comment, if those tie-in arrangements are illegal, where is the problem for you?

Mr. BECK. I think the question becomes a question of what do you regard as a tie-in sale. I've heard a previous illustration by the BankAmerica about tying in a home mortgage, homeowner insurance, all of the other papers that must be completed for convenience of the customer. There was a time in the life insurance business when a life insurance company attempted to tie a home mortgage in with mortgage insurance and that was disavowed as something that was a tie-in sale and was inappropriate.

Senator HEINZ. I think that it is clear that at least one of the reasons that nonbanking institutions do want—besides the uncertainties they have about tie-in sale implications—is the imprimatur on federally insured deposits. Would most of you agree with that? Does anybody disagree with that? I don't see a single hand go up, let the record show. Well, Mr. Caspersen's hand went up there. There's one dissent of some kind.

Mr. CASPERSEN. Our business at Beneficial is tending to the consumer's liability needs. We have found to date—and I differ with my colleagues at this table—that depository products are not necessary and perhaps they're not even helpful in doing that and, therefore, we have no significant interest in expanding our consumer deposit base even though we do have a significant one.

NONBANK BANKS ARE NO DANGER TO CONSUMER

Senator HEINZ. Now, Mr. Caspersen, a moment ago I think you said that there's really no particular danger to the public from nonbanks getting into banking, that this will not undermine the safety and soundness of consumer deposits and I think at the present time it is probably not an open-and-shut case by any means to come up with proof that you're wrong. There are some examples that I can cite, but I guess my question is, What would constitute a demonstration of the fact that the public is being placed at undue risk? What would it take? Failure of the BankAmerica or just Citibank or something else?

Mr. CASPERSEN. I think the concept that I'd like to demonstrate is that so far philosophically and conceptually that there is no danger from nonbanks getting in danger as long as the regulatory functions which are now in place are working in an operative function. Insofar as I know, they are working and what I tried to point out in my testimony ironically is those areas in which are the most closely regulated, the commercial loans and asset management which appear to be causing problems in the banking industry. It is not the near banks or the consumer banks and in fact they have weathered perhaps through the worst time since the Depression without any significant problem.

Senator HEINZ. Well, that's an interesting point I think. I think there is real difficulty in as robust and varied an economy as we have, notwithstanding the recession. What is remarkable about this economy is that we have 100 or 99 million jobs and we have had them more or less throughout the duration of what has been termed the longest recession. Unfortunately, we have a lot of new entrants into the new job marketplace, hence we have very high unemployment.

But it would appear on the surface that it's difficult to determine if our system can endure were it to be in a sense deregulated in the sense we've been talking about it here, relying solely on functional regulation, moving entirely away from institutional regulation and the safety and soundness of the institutions that that presumes.

On the other hand, I'd like to suggest there are a few things we do know. One of them is that competitive forces, however much they may and, in my judgment, certainly will result in products and innovations for consumers, also result in individual firms making an all-out effort to maximize profits and the consequence of individual firms going out to maximize profits is in the instances of some firms failure. In doing that, you take risks.

So the big difference, of course, is if you allow the maximization of competitive forces and profits, there is a cost to safety and soundness. In 1929 it was the crash. Supervision alone apparently doesn't prevent mismanagement, evidence Penn Square. Mismanagement at one institution can have an adverse impact on the solvency of other institutions, the Butcher Bank and five other Tennessee banks. The public psychology can still create a run even on an insured depository institution; namely the United American Bank in question. And the risks already permitted within the current system have necessitated us in Congress taking some fairly extraordinary measures.

Last year what Garn-St Germain did—and as Senator Riegle pointed out quite correctly I think, the reason it passed is we had to shore up the S&L's and we did so not only by saying that we stood ready to bail out the FDIC and the FSLIC but we came up with the rather ingenuous creation of income capital certificates to ensure that a little lower level of immediate participation by the FSLIC, and this year the Senate has passed and the House is yet to act on a small $8.4 billion authorization called the International Monetary Fund authorization which we are told is absolutely essential to stabilize the international monetary system and if we don't stabilize the international monetary system there will be an illiquidity and not only will the countries that suspend convertibility become terrible customers of the United States, indeed their economies will become disasters, but our financial institutions will suffer right along with it and world trade will suffer and we will have a variety of collapses.

Now the question I guess is, Since I don't think anybody is really saying that we should abandon the safety and soundness altogether, the question is, how far do we go in insuring a reasonable level of safety and soundness? Here's where it gets tough. It gets tough because you gentlemen can say, "Well, go farther than you have so far," and we have to decide exactly how far that is. The simple choice is to have Glass-Steagall or not have Glass-Steagall.

Now clearly, we are not going to repeal Glass-Steagall. The question is, with specificity, what do we do? How far should we go? Now does anybody disagree that even if we take relatively modest steps in this area to, if you will, spread the FDIC imprimateur around a little bit more in one way or another, that we will not have any higher risk of institutional failure for banks or bank holding companies?

Mr. Armacost, do you see any penalty we pay in terms of having more bank failures or bank holding company problems?

Mr. **Armacost**. I think probably the converse. I think the estimate of the strength of the marketplace is the number we have encompassed without major distress. That's not to say that it is a happy event in Tennessee or elsewhere when an institution fails, but I think the marketplace is not without risk. I think it's impossible for any structure to be put in place that guarantees no risk, and we are trying to march down that road. The public does make choices, and they are making choices. I think there is more to be gained by letting the marketplace drive those issues.

RISK TAKING

Senator HEINZ. Let me address this question I guess to you and Walter Wriston in particular as bankers. If it is true that the freedom to maximize profits does entail, because of the ability to take risks, a higher risk of failure, we know that more firms have got to fail. Mr. Wriston, himself, when he courageously went into upper New York State found out what risk taking was like. I mean, how can you say there won't be a greater risk to safety and soundness?

Mr. ARMACOST. I don't know that I would say that, but I think that Mr. Wriston would also agree that his institution is the better for having attempted that competition and having learned from it, and I dare say ——

Senator HEINZ. Aren't we all?

Mr. ARMACOST. It's accurate.

Senator HEINZ. If we survive, we're all for the better.

Mr. ARMACOST. I'm convinced that we'll survive. I'm concerned, Senator, about the presumption of profit maximization. Without wanting to enshrine any of us in nobility, I think most of us pursue market satisfaction as a primary requirement as opposed to profit maximization. If we do the first well, the second follows. And I think that's where we at least as an institution are coming from, and that is our concern with the fragmentation of the marketplace. We are really being denied from providing utility and efficiency and effectiveness for our own customers because they're forced to move to other institutions. I think in that process there is risk that drives income away from you and into others, and therefore may weaken the structure overall. I'm not sure it's black and white in terms of profit maximization and that freedom in the marketplace implies greater risk and more failure.

Senator HEINZ. I'm told that my time has expired, but if anybody has a penetrating insightful comment at this time I'm sure the chairman will allow it.

Mr. WRISTON. May I say one thing? The idea of the riskless world is a dream. All of life is a management of risks, and risk is not increased by maximization of profits per se. You can make a very low interest rate loan which goes bad and a very high interest rate loan that is repaid. So I would not accept the logical linkage that you have put on that.

Senator HEINZ. Well, can I ask this question. We are at a situation where one question that is in front of us is to impose a moratorium or not to impose a moratorium, and if one says there is, as you imply, a risk, perhaps not quantifiable but nonetheless a risk, in the lack of a moratorium, how do we measure the tradeoff between the lack of dynamism which would be manifest in imposing a moratorium and the possible dangers that would result from not having a moratorium? How do we make that tradeoff?

Mr. WRISTON. I can't for the life of me make the linkage. If you're saying that, if in addition to the 14 corporations on my chart that now own banks, that putting in 16 more will increase the risk to the consumer—I can't understand that linkage.

Senator HEINZ. Well, is there any danger to the public that would arise from imposing a moratorium?

Mr. WRISTON. Yes. Those that want to get financial services but have been blocked out will be prohibited from getting them. The consumer is the one who is voting for deregulation.

Senator HEINZ. Is that a danger or is that an inconvenience?

Mr. WRISTON. It's a danger in the sense that you're allocating markets and this country is built on a free market society.

Senator HEINZ. Now we're talking about danger to the consumer.

Mr. WRISTON. We're talking about danger to the system in which you say, you may be in this market, but not this one.

Senator HEINZ. I understand that point of view. I'm not trying to quarrel with it. I'm trying to define the position of the consumer in deregulation and certainly all of us want more convenience, not less convenience. The question is, though, if it is true that a moratorium will impose certain inconveniences on the consumer because they can't get an access to everything they might be able to get at Sears Roebuck—what, though, is the danger to the consumer, not the danger in terms of markets, but is there any danger to the consumer or is it just a question of inconvenience?

Mr. CASPERSEN. I would submit that there is a danger and the danger is quite significant in that once you take an industry and say there shall be no change in this industry, whether it be for 6 months, 6 years or 60 years, you're condemning that industry to stagnation and you will condemn that industry to eventually fail. There have been numerous examples of that, the railroads for one.

Senator HEINZ. So your position is that banks will fail if we have any moratorium?

Mr. CASPERSEN. They will fail in their function of providing the consumer and the country with a sound base of financial services.

Senator HEINZ. Well, that's not what you said a minute ago. You said they would go out of business.

Mr. CASPERSEN. I said they would fail insofar as the railroads have failed to function in this country.

Senator HEINZ. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Beck, you made a comment a few minutes ago that you didn't want to be in the banking business. Over the last 9 years on this committee I have heard every segment of the financial industry say they wanted to just stay what they were. Savings and loans want to be savings and loans. Commercial banks want to be commercial banks.

So I guess the question is, which came first, the chicken or the egg? Who is propelling all of this?

In my viewpoint, I think that I have to come down on the side, as I have the last couple years, that the commercial banks and the thrifts are the ones that were being unduly restrained because they had geographical restrictions, reserves, all sorts of rules and regulations that were not imposed on Merrill Lynch and the genius of

Secretary Regan when he introduced money market funds. And as I've said many, many times, I certainly do not criticize that kind of innovation, that kind of mental ability that figures out ways to better serve consumers. So I don't criticize Mr. Birk or Secretary Regan for doing it. I just say it as a matter of fact they found a way to serve customers that the commercial banking and thrifts were not able to do. Mr. Telling has done the same thing. There's nothing wrong, in my opinion, with him trying to maximize the service of the Sears institution or Finn Caspersen or anybody else or American Express or Prudential buying Bache. I have no trouble with that and I do believe it has resulted in better services to the consumer.

But what I have tried to do is not have government interposed making unfair competitive advantages for others. Now that's where I come down on it. So nobody wants to be anything else but everybody is. Which did come first, the chicken or the egg, in your opinion?

Mr. Beck. Are you addressing that to me?

The Chairman. Yes; because you said that you didn't want to be a bank. Does it also follow you didn't really want Bache?

Mr. Beck. No, no. That isn't a one, Senator, that we were drawn into because of other forces. The development of our long-term strategy, unlike most of my other competitors with the exception of Sears because of their All State affiliation, our objective has been to concentrate on basic strengths that we started with.

We started with an individual marketing force of agents who go out and call on people. We started with a very strong group marketing force, a force of people calling on employers all over the land and municipalities. And we started with a unique investment organization that had a capacity to provide products and services that these two other groups of people could use and distribute.

In an effort to further expand and develop the additional capacities of these marketing forces, it was a very logical step for us to go into Prudential-Bache. We had originally looked at a regional firm and had no idea at that time, because no major national firm had been moved or been acquired—we had no idea that one was a possibility for sale and so we grabbed that and jumped at the opportunity to get Prudential-Bache when we did because it was a natural extension of our long-term strategic planning.

The idea of going into a bank is not an extension of that plan. It does not capitalize or add to the special marketing strengths that we began with. So that's why we say we had no interest in acquiring a bank. Now Walter would say you already have some of the advantages of a bank and I would agree that that's true, but we are not a depository instrument nor do we make consumer loans, nor are we interested in either.

The Chairman. You see, as I look at this development, I started my business career in the insurance business with John Hancock, not with Prudential but with John Hancock. If I tried to go back into the insurance business today, I wouldn't even recognize it. The product changes have been so dramatic from when I was selling just 15 years ago that what I hear you saying is the financial services industry has changed, the securities industry has changed, it's all changed; the banks and savings and loans are supposed to be doing the same thing they were doing 50 years ago and just stay structured in whatever they were for the protection of the public without regard to the fact that the whole marketplace has changed.

I'm very serious, Mr. Beck, when I say I would not be qualified to go back in the insurance business without a lot of retraining because of the dramatic changes in product lines and everything that was being done, for example, money market mutual funds. Once again, I suppose I get put in the side of defending the traditional depository institutions, which I don't really think I am, other than to say that they have had restraints and there's two ways to go. Either we start placing new rules and regulations on insurance companies and, good heavens, I don't want to get away from McCarren-Ferguson. I want the Feds to stay out of insurance because you're last business that isn't totally dominated almost by it, so you want to be careful there too.

Mr. BECK. Senator, let me make haste to assure you, we're not looking for elimination of the McCarren-Ferguson Act.

The CHAIRMAN. I know you're not.

Mr. BECK. I might add, having started as an agent some 33 years ago with a very small rate book less than an inch thick which had all of our products and comparing that to the 3 or 4 feet of rate books and tools that our agents have now, it is a very different world.

By the way, I hope I haven't left you with the impression that I am opposed to the elimination of regulation. I'm opposed to doing it piecemeal and I would hope within a very short period of time, rather than just studying these issues we could come down specifically with decisions in each of the broad areas that are important.

The CHAIRMAN. It disturbs me to hear you say it's only been 33 years since you started from a rate book and became president and chief executive officer because it was 25 years ago for me and look where I ended up by comparison. So I'll trade you.

Mr. BECK. Having heard your comments, sir, on some of the problems you face, I don't think I'd like to.

Mr. BIRK. Think of the benefits.

The CHAIRMAN. Let me make one other comment. Both Senator Riegle and Senator Heinz have made note of the fact that Garn-St. Germain would not have passed without the problems of the thrift industry. I have made that comment many, many times in this committee room and across the country and that is absolutely true, because Congress normally doesn't want to face decisions, particularly if they are controversial at all. And the issues that we were dealing with in the original S. 1720 were very controversial, as are these. The interesting thing about it is that, as I was feeling incredible pressure—as a matter of fact, in December 1981 in one meeting alone—this is rather unique—having the Chairman of the FDIC, the Chairman of the Federal Reserve, the Chairman of the Federal Home Loan Bank Board, all of the regulatory agencies got together and put their schedules together and came to my office and told me that I simply could not persist in trying to get an overall deregulation bill passed, that I must go with title I and title II which was the matter of capital infusion and the new regulators' bill. And I was told personally over a period of 2 or 3 months that if I didn't give up, being virtually alone with pressure within the Congress and without from all the regulators, if I didn't give up, the failure of the thrifts would be on my shoulders alone, all by myself. And that's rather a large burden to bear, having all the thrifts fail.

Well, some people may have called me pigheaded or lots of other things at the time that we politicians get, but I wasn't willing to do that. So we did make some progress. I think you're right, we're in the 1970s. We're still behind the power curve, Walt. We haven't progressed nearly as far.

Now once again, where we're trying to come along and make some decisions that are old decisions—they're not really new—there isn't a new issue here that wasn't kicking around before I even became a Senator, let alone the chairman of the committee. All kinds of information are available. It's simply a matter of having the courage to sit down and make a decision and I see nothing different 6 months from now than right now. There is no reason, in my opinion, why we don't have enough information to hold a markup in the next couple weeks and make some decisions and that doesn't mean Jake Garn's decisions; that means the collective judgment of this committee to make a determination of what we're going to do with these issues one way or another, vote. Count up the majority vote on this committee and make some decisions because I feel the same sort of pressure building once again. Let's have a moratorium; let's give up.

Now if I could be guaranteed that that moratorium only lasted 6 months and by the end of this year we would make decisions, fine; I'd be happy. Six months is rather infinitesimal compared to the length of time it took us to get to last year's deregulation bill, a period of a decade or more. So I would have no objection, but I have never yet seen a moratorium that either didn't get extended or the issue is sort of gone and mushed about.

So I just wish some way there is a way to get on with it and yet I want to emphasize that that isn't my feeling that we have to adopt Jake Garn's viewpoint of what goes on, but a collective viewpoint of the Congress, far beyond just this committee.

Senator HEINZ. If the chairman would yield, let's schedule a markup.

The CHAIRMAN. We will schedule a markup as soon as we get the administration's recommendations, which as I've stated in my release last week when I introduced the moratorium by request, and in all fairness, the moratorium was not introduced by Senator Heinz and Senator Proxmire by request. As is obvious by their comments, they supported it, but I introduced it as a courtesy to the Federal Reserve; I will also introduce as a courtesy to the administration their bill, hopefully this week.

Senator HEINZ. Would it be the chairman's intention to have a markup in early or middle July?

The CHAIRMAN. Yes.

Senator HEINZ. Good. I thank the chairman.

The CHAIRMAN. Gentlemen, thank you very much. We do appreciate your attendance here today.

The committee is adjourned.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

FINANCIAL SERVICES INDUSTRY—OVERSIGHT
Part II

WEDNESDAY, JUNE 29, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Gorton and Heinz.

OPENING REMARKS OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

We continue our hearings today on the condition of the financial institutions industry. We have a distinguished panel before us this morning composed of Mr. James E. Smith, president of Charles E. Walker Associates; Garth Marston, chairman of the Providence Institution for Savings, of Boston; Philip Coldwell, Coldwell Financial Consulting; A. A. Sommer, Jr., Morgan, Lewis & Bockius, Washington, D.C.; and Muriel F. Siebert, chairman and president, Siebert and Co., New York, N.Y.

We're happy to have all of you here and, Mr. Smith, if you would like to begin.

STATEMENT OF JAMES E. SMITH, PRESIDENT, CHARLES E. WALKER ASSOCIATES, INC., WASHINGTON, D.C.

Mr. SMITH. Thank you, Mr. Chairman. It's a pleasure to have the opportunity to appear once again before this distinguished committee.

Mr. Chairman, so there will be no misunderstanding since I make my living these days lobbying and doing legislative consulting, I have provided your staff of the committee with lobbying registration statements of the clients which I am currently representing before this committee just in the interest of full disclosure.

Mr. MARSTON. Is that that big stack of papers?

Mr. SMITH. Yes, it was. [Laughter.]

I will try and summarize my statement.

The CHAIRMAN. Well, we all know you're a lobbyist now and if it makes you feel better we will certify for the record that you are a lobbyist.

Mr. SMITH. Thank you.

MODERNIZATION OF PUBLIC POLICY DEMAND CONGRESSIONAL ENACTMENTS

The technologies of electronics and telecommunications and the managerial disciplines of systems engineering place at hand the physical and intellectual resources to provide the American public with an array of convenient, reliable, high-quality, financial service products. But in order for the public to obtain the optimal benefits from these new services, it is essential that there be a reform and modernization of the public policies applicable to our financial businesses. Without such reform, we risk losing potential public benefits through the misallocation of resources and the failure to obtain in the marketplace the highest level of competitive interplay among the service providers.

The requirements of this modernization of public policy demand congressional enactments. The magnitude of the task is altogether too large to be accomplished through creative administrative actions of the financial regulatory agencies. To bring public policy to where it needs to be demands a reform that is spacious in its scope and bold in its thrust.

I think it might be useful, Mr. Chairman, as you approach that public policymaking facet, we look back over the past decade at some other deregulatory actions and I have in mind the actions that have been taken at the State level I think in nearly every State to provide reform or State branching laws to permit the deployment of ATM's, point of sale terminals, and other such devices for the convenient delivery of basic telefinancial services.

There are two examples in the decade in which Congress, I think, wisely restrained itself from applying the regulatory regimes of the thirties to two new investment and deposit products, and I refer to the NOW account development in the early 1970's and the money market mutual fund development in recent years.

Most importantly, in this committee's great involvement in both the Monetary Control Act of 1980 and the Garn-St Germain Act of 1982, you pretty well put the end to the application of deposit ceilings on depository institutions deposits and also took some important strides in giving to savings and loan associations, mutual savings banks, and credit unions urgently needed asset powers.

What do we learn from those deregulatory actions? I think there are two important lessons. First, because of the mystique and ambiguity that surrounds financial regulation, there will seldom be any broad-based, public petitioning of the Congress for deregulation and reform, but when deregulation does take place, new service products emerge, competition among providers intensifies, and public benefits thus accure and that can be said of each and every one of these deregulatory efforts in the last 10 years.

The second lesson that I think we need to learn is one of timing, that the actions taken in the Garn-St Germain bill and to a lesser degree the Monetary Control Act of 1980, particularly those relieving depository institutions of the interest rate ceilings and those granting new powers to thrifts, had those actions occurred at an earlier time in the decade of the seventies, I think it is fair to conclude that we might have avoided much of the unpleasantness that has occurred in the banking system and the savings and loan system in the last few years.

The danger of not taking action today and promptly is that you have a surrogate banking system developing and it's developing very rapidly, and if we do not find a way in a regulatory framework to fuse the two cultures—the culture of the old more regulated banking system and the newly developing less regulated diversified financial services industry—I think we will see a costly skewing of capital in the direction of the surrogate system and a needless and costly impairment of the existing traditional banking system.

So what is needed is a common framework of law and regulation that permits the interrelationship of these two cultures. Obviously, that law and regulation demands that we retain and preserve those important elements of existing regulation which are there for the protection of the payments function, the credit function, the securities function, and the insurance function. But I think it is possible—there is the collective wit and wisdom to define a regulatory system, a framework of law, in which these two cultures can be brought together.

Indeed, I think the Treasury Department and this administration has offered you a very, very useful building block in that direction. By using the affiliate approach that has been recommended by this administration, it is possible to apply traditional forms of regulation to the different financial services functions and also to assure that the depository function will be protected as it should be protected, and in terms of competition, that to the extent that insured depository institutions have some funding advantage, that that funding advantage will not be permitted to be used for the benefit of the depository's other financial affiliates.

You have before you also recommendations from the Federal Deposit Insurance Corporation which I think can go a long way to eliminating that favorable funding position of the depository institutions while at the same time bringing greater market discipline to those institutions, and I refer to proposals which would bring greater risks to large depositors in those institutions.

I find three deficiencies in the approach that's been recommended by the Treasury and I would like to quickly touch on those.

DEFICIENCIES OF TREASURY RECOMMENDATIONS

First, the bill at least as presented to the Congress last year seemed to totally exclude the thrift industry and the opportunity for cross-entry. I think that is a situation that simply cannot be permitted to obtain. The thrift is a terribly important component of our whole financial services industry and it needs to have exactly the same rights and opportunities as all of the rest of the players.

Second, I think that whereas you I think must use a holding company approach and while it is natural to look at what is there in terms of the bank holding company regulatory system, I think it would be better that your approach there be zero-based, that you look at that whole enterprise and determine its relevance and applicability to a modern system.

I think that the fact that we would be building off the bank holding company system and the bank holding company culture may create some needless uneasiness and suspicion among those elements of the financial services industry that have not been a part of that culture, that indeed draw into it somehow there are some hidden advantages for banking and what we are talking about is a law and regulation that applies to financial services companies, not necessarily banking companies.

Last, I think the proposals are deficient in that they do not address the geographic constraints that apply today on depository institutions, particularly on commercial banks. I will acknowledge that I have fallen victim in the last year or two to what I think is the conventional wisdom, and that is that we approach deregulation first from the product line standpoint, and having done that, we see where geographic restraints are still binding and do something with that at some unannounced future date.

The fact is that there are a lot of companies out there that have a limited amount of interest in new product activity, that want to stay doing what they are doing today but want to be able to do it better through being able to serve geographic markets in a more efficient way than they can today.

I think if we do not attack both product line and geographic deregulation at the same time, we again stand the risk of skewing capital decisions in the direction of the first vents that open up and that probably is not the wise way to move. If you try to open up even transitionally all of those vents at the same time, I think you're going to have much more rational decisionmaking by the various managers of financial service institutions and I think it's going to have a moderating effect because there will be so many opportunities out there that business will need to stand back and think carefully as to what it's going to do in the next 5 years. The Lord knows, we have seen the herding instinct particularly at work in the banking industry dozens of times in the last few years, whether it was REIT's or lending branches. The first opportunity to do something new, everybody ran down that hallway. You have to give them a lot of hallways and I think it will have a moderating influence.

I can close where I started. I don't think, Mr. Chairman and members of the committee, that you can expect, because of the complexity of the task, that there is going to be any public marching in the streets calling for reform, but reform is needed and the lessons we have learned from the past 10 years of reform is that reform is not destabilizing to the system and reform produces real and tangible public benefits.

Thank you very much.

[The complete statement follows:]

Statement of
James E. Smith, President,
Charls E. Walker Associates, Inc.,
Before the
Committee on Banking, Housing and Urban Affairs,
United States Senate
June 29, 1983

This does not purport to be a statement of definitive analysis or precise and detailed recommendations for the creation of a modern public policy for the financial service business. Rather, it is a few observations about lessons learned from past deregulatory actions and some general thoughts concerning the critical requirements which need to be addressed in developing a sound and workable new public policy to guide the next evolution of the financial services industry. These observations are the product of some twenty years of involvement with financial regulatory policy and a few years on the firing line in bank regulation and supervision.

The technologies of electronics and telecommunications and the managerial disciplines of systems engineering place at hand the physical and intellectual resources to provide the American public with an array of convenient, reliable, high-quality, financial service products. But in order for the public to obtain the optimal benefits from these new services, it is essential that there be a reform and modernization of the public policies applicable to our financial businesses. Without such reform, we risk losing potential public benefits through the misallocation of resources and the failure to obtain in the market place the highest level of competitive interplay among the service providers.

The requirements of this modernization of public policy demand Congressional enactments. The magnitude of the task is beyond that which can be accomplished through creative administrative actions of the financial regulatory agencies. To bring public policy to where it needs to be demands a reform that is spacious in its scope and bold in its thrust.

It may be useful to look at some of the deregulatory actions of the past decade for the lessons which they offer us.

In the early and mid-seventies, with some prodding from the Federal level, states undertook the reform of banking statutes so as to permit available technologies to be applied in providing basic teller services through automated teller machines and point-of-sale terminals situated away from established banking offices. Some counseled that these reforms would create instability in our depository system and, moreover, would yield service products which the public neither desired nor would use. By now, the evidence of enthusiastic public acceptance of this service improvement is both immense and incontrovertible. Nor have these reforms caused any discernible weakness in the banking system.

Twice in this past decade the Congress has wisely resisted the temptation to apply traditional existing regulation to innovative savings and investment products. Namely, the development of the NOW account in the early 1970's and the introduction of the money market mutual fund in the last five years. Both of these product innovations have been enormous public successes and have produced real and tangible public benefits.

Application of regulatory policies crafted in the 1930's would surely have denied these benefits to the public.

That the public responds positively to deregulation of financial services was again demonstrated by the utilization and acceptance of the deposit products which were offered after the deregulation authorized in the Monetary Control Act of 1980, and more importantly by the Garn-St Germain Act of 1982. These two enactments also took the first meaningful steps to permitting S&L's, mutual savings banks and credit unions to undertake new lending and investment services. These institutions are beginning to utilize this authority and borrowers are certain to benefit from the resulting enhancement of competition.

From these several deregulatory actions we learn at least two important lessons.

First, because of the mystic and ambiguity that surrounds financial regulation, there will seldom be any broad-based public petitioning of the Congress for deregulation and reform. But when deregulation takes place, new service products emerge, competition among providers intensifies, and the public benefits.

The second lesson is that the deregulatory actions broadening the asset powers of the thrifts and rolling back interest ceilings on deposit products should have been enacted at an earlier date for optimal effect. Had these regulatory reforms been accomplished in the early to mid-1970's, it is highly probable that most of the institutional difficulties of the thrift and banking industry in the past three years could have been avoided.

These lessons of the recent past can provide useful guidance for the formulation of new financial public policy.

In today's financial markets, where we have an increasingly uneven competition between the traditional elements of a regulated banking and public depository system and the newly emerging less-regulated diversified financial companies, there lies a promising opportunity through public policy modernization to give the American public a greatly improved access to efficient and high quality financial services through fair, but greatly intensified, competition among financial service businesses. But there also lies a threat; for if we fail to update public policies in a timely fashion, there may well develop a "surrogate" banking system with a skewing of capital allocations to that "surrogate" system and a resulting needless and costly impairment of the existing banking system. Thus, the timing of public policy reform is nearly as important as the substance.

What is needed is a new public policy providing a common framework of legal standards and regulatory requirements which will apply even-handedly to both the old and the new cultures of our financial services industry. This new public policy must have the dual objectives of preserving those essential regulatory constraints designed to maintain safe and sound performance of the payments, credit, securities, and insurance functions, but affording the flexibility to accommodate the synergistic interrelationship of financial service activities, so as to obtain greater productivity and economic efficiencies.

The Reagan Administration, through its Treasury Department, has presented the Congress with a legislative proposal which is a most innovative and valuable building block for the formulation of a modern national financial regulatory policy.

The Administration proposal permits the interrelationship of the traditionally closely regulated banking function with the other less-regulated financial functions through separately incorporated subsidiaries housed within a holding company superstructure. Also, importantly, the proposal establishes comprehensive "arm's-length" requirements on all interaffiliate transactions with the banking affiliates to provide both the necessary safety and soundness protection of the banking affiliates and to assure that the assumed funding advantages of a Federally-insured depository cannot be used for competitive advantage by its non-bank financial affiliates. Funding advantages of the Federally-insured institutions can be reduced and market discipline of these entities can be increased by modifying our deposit insurance programs to place greater risk on large depositors.

The genius of the Administration's proposal is that through the structural arrangement of separately incorporated affiliates, it is possible to provide traditional regulatory treatment to the different financial functions, and thus assure uniform and evenhanded regulation of all competing enterprises -- an absolutely essential requirement.

Some questions have been raised if this affiliate structure provides adequate protection for the safety and soudness of the Federally-insured depository affiliates. There should be no serious dangers in this regard, providing the regulatory agencies having primary responsibility for the depository affiliates have the clear authority to keep fully informed on the financial condition of the parent and non-depository affiliates (through examination, if necessary), and the authority to direct divestiture of the depository affiliate from the holding company in the case of unusual financial difficulties. There is precedent for this kind of supervisory action.

To repeat, the Administration's proposal is an excellent building block for the construction of a modern public policy, but it is deficient in at least three respects!

First, in building from the existing culture of bank holding company regulation there is a danger that this highly constructive proposal will be viewed with distrust by non-bank financial companies, out of a concern that it may contain some hidden and inherent bias in favor of banks. Such reaction will create needless political complications. What a modern financial policy should be designed for is the creation of a legal and regulatory code for diversified financial services companies -- not banking companies. Accordingly, while it may be valuable to review our experience with bank holding company regulation in formulating policies for modern financial companies, that review must be zero based.

Second, the Administration proposal, as presented last year, failed to include the whole family of thrift institutions. Such exclusion raises real questions of fundamental equity, as well as of market efficiency.

The thrift industry is a most important component of the national financial services sector and must have the full opportunities for reciprocal entry into all other financial businesses.

Third, the Administration proposal fails to deal with the critical need to materially liberalize, if not totally repeal, the existing Federal restraints on geographic market extension by Federally-insured depository institutions. These restraints are most onerous in the case of banks.

The conventional wisdom seems to be that the process of updating financial regulation should begin with product-line deregulation (or perhaps reregulation) to be followed by liberalization of geographic constraints at some unannounced time in the future.

Such thinking is flawed by the assumption that all financial service providers wish to undertake a substantially similar mix of activities. That is absolutely wrong and, moreover, public policy should not create rigid channels of opportunity that force this result.

There are many depository institutions, which have only the most modest desire to expand into new lines of business. Rather, their desire and need is to extend their existing lines of business into new geographic markets.

Moreover, given the fact that depository institutions have been tightly restrained both as to activity and location, it follows that there will be a natural tendency to rush capital investment to whichever vents of opportunity are first opened. If the venting is highly limited, it can well lead to a disastrously inefficient allocation of capital and human resources.

All financial enterprises have finite limitations on the capital which can be deployed for entry into new activities and for expansion of existing business. The decision making of capital allocation will be moderated and made with greater rationality and discrimination if the Congress moves simultaneously to reduce both the product-line and geographic barriers to natural competition.

This deregulation can be undertaken transitionally by phasing in new authority over a period of years. What is necessary for efficient business planning is that the timetable be firm and explicit.

We have learned from past deregulatory actions that real public benefits are produced. Because of the complexity of financial regulation, it is wholly unrealistic to expect public opinion to lead the march for reform. Congress will have to take this initiative, but it can do so comfortably in the knowledge that reregulation which intensifies competition among financial service providers is clearly in the public interest.

The CHAIRMAN. Thank you, Mr. Smith. My experience in the last 2½ years is just the opposite. There's a great deal more pressure just to maintain the status quo and not do anything, regardless of how shortsighted that may be.

Mr. Marston, Mr. Smith has been so forthcoming, is there anything you would like to disclose before you testify?

Senator GORTON. Mr. Chairman, could I interrupt at that point?

The CHAIRMAN. Certainly.

Mr. MARSTON. Are you going to disclose something about me, Senator?

Senator GORTON. I'm going to disclose something about you, Mr. Marston.

Mr. Chairman, I simply wanted to say as a preface to Mr. Marston's testimony that he bears a very real responsibility for my being here. Mr. Marston was the president of the Young Republicans of King County when I moved to Seattle and he welcomed me to that organization and began me on a path which not perhaps inevitably but nevertheless led to this point. So he bears a very real responsibility here and I'm afraid he probably was not going to disclose that to you, so I thought I should do so.

The CHAIRMAN. Well, I will take that under consideration as I watch your performance on the committee and see who I need to blame. The only thing I don't understand about Garth is why he would leave Washington State and come to Washington, D.C. and end up in Massachusetts.

Senator GORTON. He went in exactly the wrong direction.

The CHAIRMAN. That's true. For those of you who don't know, I'll make a disclosure. I lived in Washington State for a number of years and I have one child who is a native Washingtonian.

Mr. MARSTON. Senator, as the president of your University of Utah said as he was heading to California, "It's the best offer I got.

The CHAIRMAN. Please continue.

STATEMENT OF GARTH MARSTON, CHAIRMAN, PROVIDENT INSTITUTION FOR SAVINGS, BOSTON, MASS.

Mr. MARSTON. Thank you, Mr. Chairman. I'm really delighted to be here and I can't help but note how the quality of the membership of your committee has gone up in the last couple years. I've spent the last 4 years just trying to survive. While it's been a very enlightening experience, I'm always pleased to come down here because it does stimulate some thoughts. It helps bring some thoughts into focus that I have but have not had the opportunity to put down on paper. So I offer my comments today as those of a former regulator who's been out in the world of hard knocks, profit and loss, mainly loss, and offer them as a point of departure more for discussion purposes.

How long would you like us to take, Mr. Chairman?

The CHAIRMAN. Well, if we could keep your remarks about 10 minutes, then we would put your full statement in the record, and I might say, as long as we've had this interruption, at 10 o'clock we are going to save the President's tax cuts, so both Senator Gorton and I will have to leave to vote and we will return as quickly as we can.

Mr. MARSTON. All right. I had five various categories that I would be prepared to discuss. One was simply reaffirmation of my view of the markets. The second was an improvement in the mortgage lending instruments and practices that won't break anyone hopefully, but might mean lower rates to the extent of 5 or 10 percent. Third, a comment on the obstruction of the functioning of the dual system. Fourth, how States could be encouraged to save the Federal Government dollars. I don't know if that's of interest to people in Washington, D.C. or not. It is in Boston and around the country. Finally, perhaps a suggestion or two for an improvement of the attractiveness of AML, alternative mortgage loans.

SUGGESTIONS OF LOWER COST OF MORTGAGE FUNDS

I think what I'll do at this point, hoping that those other points will pique a little curiosity and discussion later on, I will just talk about reaffirmation of my view of the market and also suggest improvements on how we might lower the cost of mortgage funds to borrowers.

Basically, I believed before I came to Washington and I believe now that free markets always prevail. And what that tells me, Senator, is "let us design our own products." Deregulation should include deregulation of rates as well as of terms and conditions of the instruments that we offer. The mortgage market in terms of rates and terms and conditions are inevitably and inextricably tied in with the free capital markets.

Sometimes it's difficult for those of us who have lived in a regulated environment to fully appreciate and understand that. Recently in Boston the Provident had an opportunity to make some commercial loans which are basically deregulated, these commercial loans have a 5-year rollover with a 13.5 percent initial rate. We wondered where we could get the money to fund these. There were a number of alternatives. We finally went to the public and offered 11 percent for 5 years. The key provision that we put in, both on the asset side and on the liabilities side. was a 5-year lockin. If either party wanted to get out early, they could do so but only with market penalties. You had to bear the consequence of the market penalty if you wanted to get your money back faster or, on the asset side, if you wanted to pay your loan off faster than scheduled. We advertised for funds and raised about $9.8 million in a period of 21 days. The market prevailed and that enabled us, again with the commercial real estate loans, to lock in the spread over a 5-year period.

This leads me to the second point. It seems to me that we need some improvements in mortgage lending instruments and practices. As I said, there's a possibility that this could lead to lower rates by as much as 5 or 10 percent. Fixed rate mortgages are going now for about 13 to 13.25 percent, packaged for the secondary market.

The single family dwelling mortgage suffers in general from several market-related problems. One is that there's a "put" but no "call." The borrower has the put to the lender but the lender cannot call that mortgage away. It's the "heads I win, tails you lose" syndrome. As Dick Pratt said last March, if you're making 12 percent fixed rate mortgages today for your own portfolio, you are betting that for the next 10 years—the average duration of that mortgage—that rates will not go up or go down. If rates go up, the cost of your liabilities go up, as they have over the last 3 or 4 years, and you're squeezed with no margin or a negative margin. If rates go down, the borrower is at liberty to exercise his put. He will come in and refinance to take advantage of the lower rates. That's a put without a call.

The second problem is that the mortgage is subject to retroactive changes. Each example does not apply in all jurisdictions but they include interest on impounds imposed on existing loans. To rub a little salt in the wound those are mandatory on escrow accounts. Second, changes in collection and foreclosure procedures. Those have been imposed by a number of jurisdictions, including FHA. And finally, and I know you have been addressing this and I think this is fairly well taken care of, the abrogation of due-on-sale clauses on existing contracts. To me, a deal is a deal. It should remain a deal. If one wants to change the conditions on future deals, that's all right. But loan contracts have been subject to retroactive changes.

Third, the mandatory elimination of prepayment penalties, coupled with a regulatory restriction on origination fees.

IMPORTANCE OF MORTGAGE POOLS

It's important for just a moment to look at the importance of mortgage pools. I'm referring to the pools assembled and sold by GNMA, FNMA, and FHLMC, and by a growing number of private pools that are springing up around the country.

The pools began in 1964 and today they hold roughly $164 billion worth of mortgages. In the last 2 years, they have provided roughly 74 percent of new funds and even in the last few months, with rates down and mortgage activity picking up on the part of other lenders, they are still providing almost half of the new funds. The mortgage pools are an important part of our mortgage system today. They are important.

Among the pool managers and the buyers of the securities by which the pools are financed, there is a growing number of complaints regarding prepayments. There was a secondary mortgage conference back in the late winter. One of the major complaints was that the prepayments on high rate loans were such that it reduced tremendously the attractiveness of these pools. In a declining rate environment, prepayments are increased due to three basic factors. One, the mortgage becomes more attractive and affordable on the part of the borrower; two, the purchase and sale activity in the market naturally increases. We can buy and sell homes more easily. And third, a lot of people come in to refinance to take advantage of lower rates. I don't know what national statistics are, but in the winter and early spring at our shop roughly 40 to 50 percent of our volume involved refinances rather than the financing of a new sale.

In my written testimony on chart No. 7, this indicates the reaction in the marketplace in a declining environment to this prepayment phenomenon. I'm going to give this to my friend, Phil Coldwell, whom I'm sure will criticize it soundly and roundly, but in the high rate environment back in the first quarter of 1983, the spread between 14 percent bonds and 8 percent GNMA's was about 37 basis points. That spread widened as you see, and so in the second quarter of 1983—these are New York Times statistics—the spread widened to 189 basis points. So you might say that the difference between the two, 152 basis points, is the premium that the market is exacting due to the prepayment phenomena. As I indicated earlier, faster prepayments at this time are partly because of aging of the portfolio and also because of the regulated aspects of it in addition people are coming in to refinance their high rate mortgages.

The market seems to be building in a prepayment premium especially as rates go up because they recognize that as rates go up they are not in fact locking in these higher deals.

Finally, my proposal which might result in a 5- to 10-percent cut in rates would include these factors, and I suggest that the market ought to be allowed to prevail so as to permit: First, due-on-sale clause enforcement; second, a prepayment adjustment—not penalty—adjustment; third, this adjustment should be at a premium or at a discount; fourth, it should be allowed to be applied to both total or partial prepayments; fifth, at market rates; and sixth, for AML's, we should have adjustable adjustment periods as selected by borrowers from alternatives offered by lenders.

Mr. Chairman, items 1 through 5 are discussed in my written testimony starting on page 17. Item 6, the adjustable adjustment periods, is discussed in the addendum, and the reason they're in the addendum is we didn't dream up the idea until Monday afternoon and didn't have time to get it in the body of the testimony.

Again, I want to thank you very much for this stimulating experience. I hope that it does stimulate some questions and answers. And while you're over there, I know Mickey Siebert and I will have a chance to talk about what we could do to encourage the States to save the Federal Government money. Thank you very much.

The CHAIRMAN. Thank you very much, Garth, for a very complete and detailed statement.

[The complete statement follows:]

Oral

Statement by

Garth Marston

Chairman, Provident Institution for Savings

We're all aware of the tremendous changes that have taken place in recent years among thrift institutions. Soaring interest rates forced the deregulation of the liability side of their balance sheets, a process which began in the 1970s and is now nearly completed. The alternative would have been massive disintermediation. The problem is that the thrifts' asset side has not been similarly deregulated, particularly the terms under which new mortgages are issued. I point especially to the need for regulatory change or legislation that would allow any thrift institution to include a prepayment adjustment in its mortgage contracts.

Let me explain why this is so needed. Deregulation of yields and maturities on thrifts' deposits has resulted in higher cost for funds and much shorter average yields in portfolios. The most straightforward reaction to these changes, particularly in view of the huge shift of funds to the thrifts from the money market funds, is to concentrate on adjustable repayment mortgages. By matching maturities of the liabilities with the adjustment period of the loans spreads can be locked in and the thrifts can avoid the suicidal situation of issuing 30 year bonds based on overnight money.

Unfortunately, adjustable prepayment mortgages have not proved that popular. In part it may be that they are simply priced wrong. Many thrifts seem to be pricing them in relation to long-term mortgage rates and overpricing them in relation to their costs of funds. Fortunately, the Federal Home Loan Bank Board through Freddie Mac is now actively addressing this pricing problem. But even beyond that, it is clear that many people simply prefer long-term fixed rate mortgages. A Lou Harris Poll conducted for Fannie Mae shows that 72% of all homeowners and renters would prefer fixed rate mortgages even if adjustable rate mortgages were available at considerably lower rates. Mortgage borrowers are probably simply more familiar with long-term fixed mortgages, but they may be risk adverse and prefer the repayment schedule certainty of a fixed rate instrument.

Under these circumstances the logical thing for non-suicidal thrifts to do is to sell off all the long-term fixed rate mortgages they originate and keep only those adjustable rate instruments that can be matched in maturity to their deposit accounts. Fortunately, the mortgage pools stand ready, willing and able to buy these long-term mortgages. In fact, their willingness and popularity probably guarantee that the long-term mortgage will continue to exist regardless of the thrifts' problems.

Now that we see long-term fixed rate mortgages are likely to continue because many people like them and the pools will buy them, we have to face the prepayment issue head on. Earlier, mortgage borrowers who could prepay without any fee played a wonderful game of "heads I win, tails you lose" against the thrift institutions and the small savers who provided their funds. If interest rates went up the mortgage borrower could simply sit tight and enjoy a submarket rate while the thrift was forced to pay more for the funds used to support his mortgage. The problem is that the thrift had no symmetry on the downside. When rates fell, the mortgage borrower could simply refinance at lower rates. In this situation the borrower never lost and the lender and small saver never won.

Now, however, with the development of the mortgage pools and the deregulation of the thrifts' liability side, it is the mortgage pool investor who calls the tune and determines mortgage rates. Furthermore, this investor has absolutely no interest in sitting by while his return is reduced by an avalanche of mortgage prepayments. Analysis contained in my written statement demonstrates that in the last year these mortgage pool investors have demanded about 150 basis points more in yield in order to protect themselves against mortgage prepayments.

These higher interest rates mean that in effect it is the borrower who is now absorbing the risk of losses due to prepayment and replacing the thrift institutions and small savers in large part. This in effect means that home mortgage borrowers are paying more than if the prepayment risk did not exist. More importantly, the long-term homeowners are now subsidizing short-term housing speculators and others who prepay their mortgages.

There is a rather simple solution to this problem which is not only equitable, but it also acts to reduce mortgage rates and make housing more affordable to many Americans. It is a prepayment adjustment that essentially treats the mortgage prepayer as a bond issuer who calls his outstanding obligation at the current market price. I emphasize the use of the market to set the fair price even though it is tempting to consider a formula that would reflect the market or at least current conditions. The problem is that markets can change tremendously making any such formula obsolete. I remind you that years ago controlling passbook rates by regulation seemed like a perfectly sensible way to keep the thrift industry from killing itself through competition. Few then dreamed, however, that interest rate increased would be so huge as to force a development of alternative investment vehicles for savers and to threaten the very existence of a thrift institutions. In the future, tying a prepayment adjustment to the open market is probably the only way to avoid a similar problem with certainty.

How would this proposed prepayment adjustment work? The example of the bond issuer may help explain it. If interest rates have risen between the time a bond was issued and the time the issuer wants to buy it back on the open market, the price of the bond has obviously fallen. The issuer can then buy it back at a discount from the original issue price. If on the other hand, interest rates have fallen, the price of the bond has risen from par and the issuer would need to pay a premium to buy back his bond from the market.

The mortgage prepayment adjustment would act the same way. If the mortgage borrower wishes to prepay his debt, he must provide the lender with an amount of capital which when reinvested at current market rates will produce the same level of income for the remaining period of his obligation. If interest rates have risen since he took out his mortgage, he needs to provide less than the remaining principal because the lender can reinvest at a higher rate to achieve the same income stream. On the other hand, if rates have fallen, the mortgage borrower needs to pay more than the remaining principal because the lender would be reinvesting at a lower rate. My written submission shows some specific examples and a table showing a number of alternative prepayment adjustments. For example, if a $100,000 mortgage is taken out at 12½% and prepaid 5 years later when mortgage rates are 12%, the prepayer would need to pay about $3,500 in addition to the remaining principal. On the other hand, if rates rose to 13% in 5 years, the prepayer would receive a bonus of about $3,300. The prepayment adjustment is designed to work in both directions.

It is important to realize that only those who prepay their mortgages are affected by this adjustment process and they may gain or lose, depending on which way interest rates have moved since their mortgages were originated. Again, they are essentially bond issuers who redeem their bonds at market prices before maturity. On the other hand, like the bond issuer who waits to maturity and redeems his obligation at par, the mortgage borrower who does not prepay has indeed a long-term fixed rate mortgage whose repayment schedule is absolutely fixed.

The important effect of this proposed prepayment adjustment would be to lower long-term mortgage interest rates. Investors in those obligations would no longer fear that their returns could be reduced by prepayment in times of interest rate decline. For example, I mentioned earlier that investors now seemed to be demanding 150 basis points extra on long-term mortgage obligations to guard against prepayments. If this prepayment were not needed, the $120 billion in single family mortgages that we expect to be issued this year would cost homeowners almost $2 billion less in interest payments. That may be a small number by current federal deficit standards, but I think any of us could comfortably retire on it!

Lower interest rates, of course, would especially benefit mortgage borrowers who don't refinance. They also would help thrifts who, contrary to our best judgment, continue to hold long-term mortgages that are not offset by matched maturity sources of funds. Their interest revenues on these mortgages might be a bit lower, but at least they wouldn't any longer be involved in the "heads I win, tails you lose" game with mortgage borrowers. Perhaps most important, the lower long-term mortgage rates promoted by our proposed prepayment adjustment would increase housing market activity by making homes more affordable. The Census Bureau estimates that each 1% decline in mortgage rates makes housing affordable to another 100,000 families.

Of course, in applying a prepayment penalty, thrift institutions may want to take account of special cases. Fairness and equity certainly indicate that people who are simply speculating in housing should no longer enjoy the privilege of having no prepayment penalty. For hardship cases, such as people who are transferred due to job location changes, a thirft institution may choose to waive or reduce a prepayment adjustment.

It would also be possible to structure an option under which the prepayment adjustment in either direction would be limited. Some mortgage borrowers, for example, might want to limit the premium they would need to pay to "buy back their bond" to 5%. At the same time they might be willing to limit their potential gains to the same 5% figure. Thrifts could accommodate such desires but perhaps would choose to do so at higher initial mortgage rates.

With the deregulation of the thrift institution's liability side, the cost of funds has increased and the maturity of portfolios has shortened considerably. This leaves the thrifts with two logical choices: either to issue adjustable rate mortgages whose rate adjustments are linked to the maturity of the supporting funds, or to issue long-term mortgages -- which many borrowers still prefer -- to the mortgage pools.

Without a prepayment adjustment, the interest rates demanded by investors in mortgage pools extract a premiim to offset the high likelihood that mortgages will be prepaid before maturity in periods of interest rate declines. Consequently, the long-term homeowner who does not prepay his mortgage is paying a higher than necessary rate and subsidizing those who do prepay.

This problem could be easily solved by regulatory changes or legislation that would allow any single family mortgage lender to include a prepayment adjustment in new mortgage contracts. With our proposed adjustment, the mortgage prepayers would be in the same position as bond issuers who buy back their obligations in the open market before maturity. The premium paid or the discount received to "buy back their bond" would be strictly determined by then-current mortgage rate levels.

This prepayment mechanism would shift the risk entirely to the prepayer. Long-term mortgage borrowers would enjoy lower mortgage rates in return for adhering steadfastly to their repayment schedules. Thrift institutions that retain long-term mortgages in their portfolios would no longer suffer the revenue losses that come from penalty-free prepayment. Most importantly, long-term mortgage rates would tend to be lower, therefore making an important contribution toward solving the tremendous housing affordability issue that now confronts the nation.

June 24, 1983

Statement by

Garth Marston

Chairman, Provident Institution for Savings

MORTGAGE PREPAYMENT ADJUSTMENTS: A TIMELY AND NEEDED COMPONENT OF THE DEREGULATION OF THRIFT INSTITUTIONS

The current trend toward deregulation of thrift institutions has had a profound effect on the industry. The removal of restrictions on interest rates on deposits has created tremendous changes, as has the broadening of thrifts' powers, under which they can expand into new and profitable areas.

The most recent example of deregulation, the Garn-St. Germain Act of 1982, concentrated on the liability side of the balance sheet. Two new accounts, Money Market Deposit Accounts (MMDA's) and SuperNows, were created and a schedule for the removal of restrictions on the rates of existing accounts was established. Furthermore, thrifts were allowed limited access for the first time to new markets such as commercial and consumer loans. These strong measures were taken in order to increase the thrifts' competitive position in a rapidly changing financial environment.

The recent spate of deregulation has been beneficial, but should not stop with deregulation of interest rates on deposits and access to new markets. Restrictions should also be removed on the terms of the thrifts' most important asset, single family home mortgages. Changes in the terms and conditions of mortgages are particularly important for the thrifts because despite recent setbacks, they are still a major force in the mortgage markets. Over 90% of thrifts' assets are in residential mortgages. The thrift industry originates over one-third (38%) of all mortgages and provides funds for over one-fifth (21%) of them. Before the credit crunch of the 1980's, the thrifts accounted for over one-half of all originations and new funds.

The Garn-St. Germain legislation has shown that both consumers and investors can benefit from deregulation, and we feel that this trend should be continued. The removal of restrictions on the terms of mortgage contracts is yet to be accomplished. One essential regulatory change is the development of a market-oriented prepayment mechanism on single family mortgages. A properly structured prepayment adjustment can lower mortgage rates to the benefit of mortgage borrowers and those who are shut out of the housing market by today's still-astronomical rates.

Liability Side Deregulation

The changes in regulations affecting the liability side of the thrifts' balance sheet have improved the thrifts' competitive position in the market place, but have also affected the basic nature of the thrift industry. The creation of the new Money Market Deposit Accounts (MMDA's), which were first offered on December 14, 1982, marked the beginning of a turnaround for the thrift industry. Immediately after these accounts became available, disintermediation of funds from thrifts stopped. As Table I shows, MMDA's attracted huge new inflows of funds, reaching the total of $104 billion in deposits as of April, 1983, according to the latest available data. Evidence from commercial banks, which have experienced a 6% increase in MMDA's since April, would suggest that this trend is continuing.

Although there is no precise measure, analysts believe that about 60% of the funds that were deposited in MMDA's came from sources outside the thrift industry. The bulk of these funds came from Treasury securities, perhaps the stock parket, and from the MMDA's arch-rivals, money market funds (MMF's). Even the 40% which shifted within banks came primarily from other high-yielding time deposit accounts and large certificates of deposit CD's . Only 5% -10% of the total funds came from passbook and checking accounts. Therefore, while the funds shifted from these low-yielding accounts are more costly for the thrifts, the MMDA's have also attracted over $60.3 billion in new funds.

The freedom to set rates as they wish has increased the thrifts' competitive edge vis a vis their rivals, the money market funds. After the initial burst of high introductory rates, thrifts have settled into a more rational pricing policy for their MMDA's and, as Table II shows, the spread between their rates and those offered by MMF's has narrowed. One must adjust for the differences in reporting of yields (30-day yield for MMF's vs. annualized yields for MMDA's). Ultimately, though, MMDA's should trade at a rate slightly below MMF's because of the additional safety inherent in FSLIC insurance. This slight competitive edge assures the thrifts of an important place as depository institutions and suggests that they will remain in the market place as long as they can invest their funds wisely.

TABLE I

DEPOSITS IN MONEY MARKET DEMAND ACCOUNTS AT SAVINGS AND LOANS INSTITUTIONS

(Billions of Dollars)

	Total	Monthly Inflow
Dec 1982	$33.6	$33.6
Jan 1983	76.5	42.9
Feb	94.6	18.1
Mar	102.5	7.9
Apr	104.5	1.9

Source: Federal Home Loan Bank Board

June 1983

TABLE II

COMPARATIVE RATES FOR YIELDS ON MONEY MARKET FUNDS AND MONEY MARKET DEPOSIT ACCOUNTS

	Money Market (30 Day yield)	Money Market Deposit Account Rate
March 30	7.77%	8.31%
April 6	7.84	8.38
13	7.89	8.34
20	7.94	8.24
27	7.96	8.20
May 4	7.95	8.17
11	7.91	8.13
18	7.88	8.12
25	7.85	8.15
June 1	7.79	8.20
8	7.85	8.22
15	7.96	8.23

Source: The Bank Rate Monitor, Donaghue's Money Fund Report.

June 1983

Shorter Maturity Portfolios

While the new MMDA accounts have helped the thrifts compete for funds, they have also exacerbated one of the industry's long-standing problems -- short portfolio maturities. Even before MMDA accounts, thrifts had very short maturities on most of their assets. As we see in Table III, 19.1% of the thrift industry's deposits were in liquid assets in March of 1982. By March of 1983, that share had grown to 32.4% due to inflows to MMDA's. Considering the continued growth of MMDA's, this liquid share is no doubt even larger today.

The removal of interest rate restrictions on six-month certificates of deposit, scheduled in steps until 1986, may help to reverse this trend. Six-month certificates accounted for 35.5% of all deposits when the only alternatives were 5¼% passbook and zero interest-bearing checking accounts. These six-month accounts dropped to a 22.7% share, however, when the high-yielding, liquid MMDA's and SuperNows appeared. When all rates are unrestricted, including those on certificates over six months in duration, thrifts may offer higher yields on longer-term assets in order to enable better matching of maturities with assets.

Adjustable Rate Mortgages

With the inherent characteristics of short liability portfolio maturities, the logical choices for investment by thrifts are short-term assets, including variable rate mortgages. With variable rate mortgages, the thrift can match maturities and set its yields on the basis of the cost of funds. Since revenues and costs will move in tandem, a fixed spread is guaranteed and the income provides funds for operating expenses and profit.

For example, our institution is currently offering an Adjustable Rate Mortgage (ARM) with adjustments each year, the future rate being equal to the Treasury bill rate plus 250 basis points. Since our cost of funds on MMDA's is set at 50 points above Treasuries, this locks in a 200 point spread for us to run our business.

TABLE III

DISTRIBUTION OF FUNDS AT SAVINGS AND LOAN INSTITUTIONS

Liquid Accounts	March 1982	March 1983
Pass Book	17.4%	12.2%
Checking	0.0	17.4
MMDA	0.0	1.0
Super-NOW	1.7	1.8
	19.1%	32.4%
Maturities		
7-31 day	0.0	0.9
91 day	0.0	0.3
6 month	35.5	22.7
1 year	3.9	0.7
1½ year	0.7	1.7
2½ year	20.8	23.2
3½ year	0.0	2.2
Other	10.4	6.3

Source: Federal Home Loan Bank Board

June 1983

Unfortunately, the pricing of ARM's in the marketplace does not always conform to the basic maturity matching theory. Some thrifts set their initial ARM rates on the basis of long-term rates rather than cost of funds, and later yield adjustments are determined by indexes like the Federal National Mortgage Association (FNMA) auction rate. Chart I shows that earlier this year the 60 day adjustable ARM's moved more in tandem with long rates than with the cost of 60 day T-bills. This phenomenon is due to inexperience in pricing these instruments, and may account in part for the lack of market acceptance of ARM's. Fortunately, the Home Loan Bank Board is now addressing the issue of correct pricing for ARM's through the Federal Home Loan Mortgage Corp (Freddie Mac). It also reflects the continued dominance of long-term fixed rate mortgages in the marketplace.

Homeowners Prefer Fixed Rate Mortgages

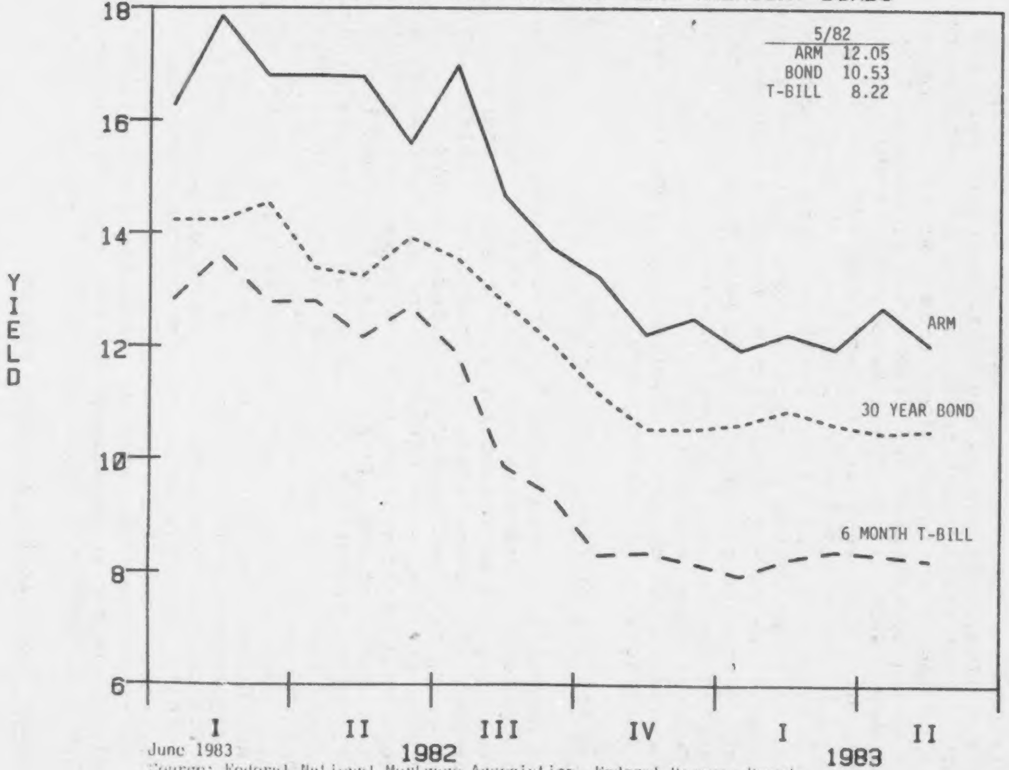
ARM's have also proved unpopular in the marketplace for other reasons. Consumers prefer fixed rate mortgages because they are more familiar with them. Furthermore, since they are risk-averse, many consumers dislike the uncertainty involved in ARM's. A Louis Harris Poll conducted for FNMA showed that 72% of all homeowners and renters would prefer fixed rate mortgages even if ARM's were available at considerably lower rates, and hence lower monthly payments. Further proof of the preference for fixed rate mortgages is presented in Chart II which tracks the share of new mortgages that had adjustable rates. Even in August 1982, after rates had peaked at 17% and fixed rate contract rates were 23 basis points over adjustable rate mortgages (see Chart III), more than 50% of consumers took fixed rate mortgages. If they wanted long-term fixed rate mortgages then, they really wanted them! Furthermore, at that time many transactions involved creative financing which primarily involved fixed rate contracts, so the actual penetration of ARM's has probably never passed one-third.

Mortgage Pools in the Mortgage Market

The continued dominance of the fixed rate mortgage in today's mortgage market is largely attributable to the growing importance of mortgage pools, sponsored by various government agencies and by private mortgage makers and insurers, as the primary lender of new funds.

CHART I

MONTHLY YIELDS ON ADJUSTABLE RATE MORTGAGES VS SIX MONTH T-BILLS AND 30 YEAR TREASURY BONDS

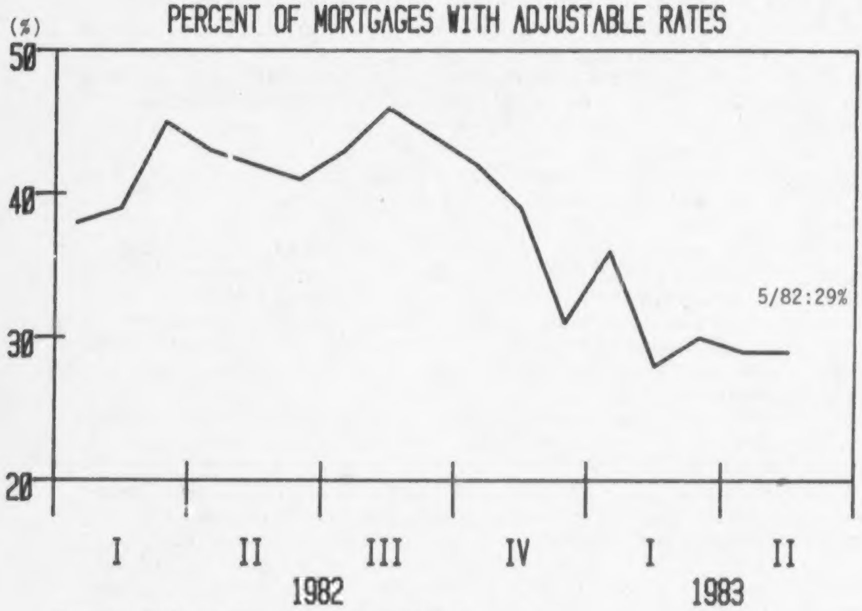


June 1983

Source: Federal National Mortgage Association, Federal Reserve Board.

CHART II

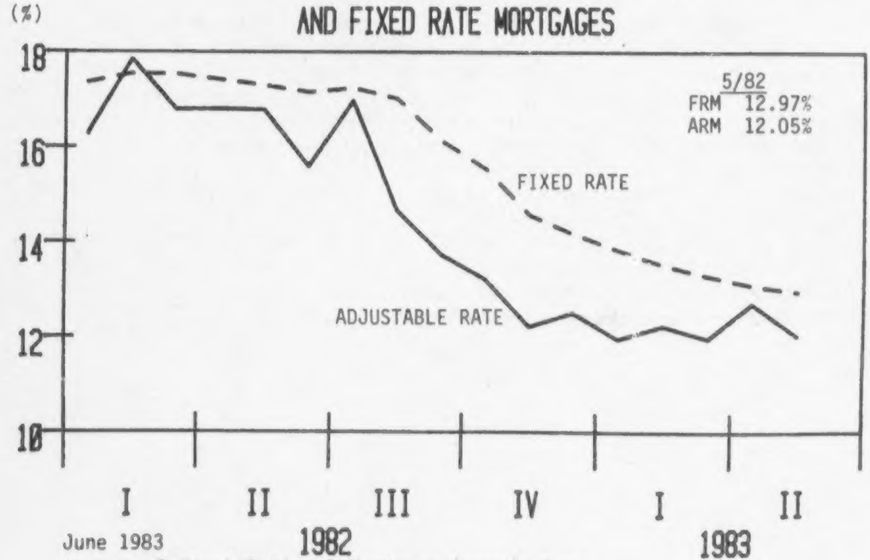
PERCENT OF MORTGAGES WITH ADJUSTABLE RATES



Source: Federal Home Loan Bank Board.

CHART III

INTEREST RATES ON ADJUSTABLE RATE AND FIXED RATE MORTGAGES



June 1983

Source: Federal National Mortgage Association, Federal Home Loan Bank Board.

As Chart IV shows, the pools, which began in 1964, now hold $163.5 billion in mortgages. During the past two years when the thrifts were facing extreme disintermediation, the pools emerged as the primary lender of new funds, providing 73.8% of the new funds that the mortgage market needs (see Chart V). Some of these funds represented purchases of old mortgages from thrifts and banks under a government sponsored swap program. Yet even now that the program has wound down, the pools provide nearly half (46%) of all new funds.

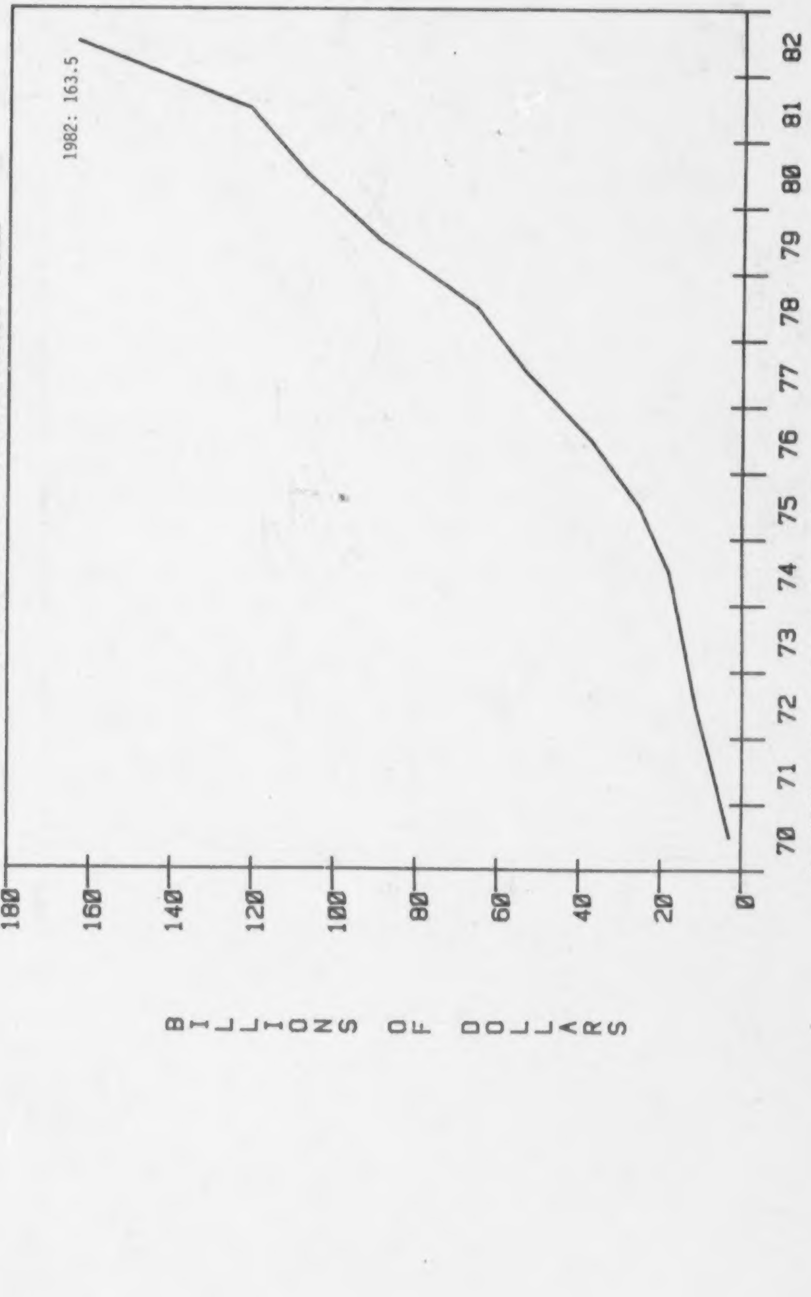
The pools can continue to finance fixed rate mortgages because unlike thrifts, they fund their purchases through the sale of securities ranging in maturity from 1 to 30 years. They sell these mortgage-backed bonds or pass-through certificates largely to institutional investors, such as pension funds or insurance companies,who prefer long-term assets with steady cash flow. The largest of the pools, Ginnie Mae (Government National Mortgage Association, GNMA), Fannie Mae (Federal National Mortgage Association, FNMA), and Freddie Mac (Federal Home Loan Mortgage Corporation, FHLMC), are all federally sponsored. GNMA deals only in Federal Housing Administration (FHA) loans and cannot make loans above $90,000. Similarly, FNMA and FHLMC are restricted by their charters to issuing mortgages no larger than $108,300. The remainder of the market is left to the private pools generally run by mortgage bankers and issuers such as the Mortgage Guarantee Insurance Corporation (MGIC) and Verex.

Thrifts and the Mortgage Pools

Due to the existence and huge size of the mortgage pools that buy principally long-term mortgages, these long maturities should continue to account for an important part of the market, even if ARM's are priced attractively. As noted, mortgage borrowers will probably continue to be attracted to long-term mortgages due to their familiarity with these instruments and the certainty of the repayments. Consequently, most thrifts should continue to offer fixed rate mortgages, which they then package and sell in the secondary market. Chart VI shows that the vast majority of lenders act as originators for fixed mortgages. Chart VI shows the divergence between originations and acquisitions to their own

CHART IV

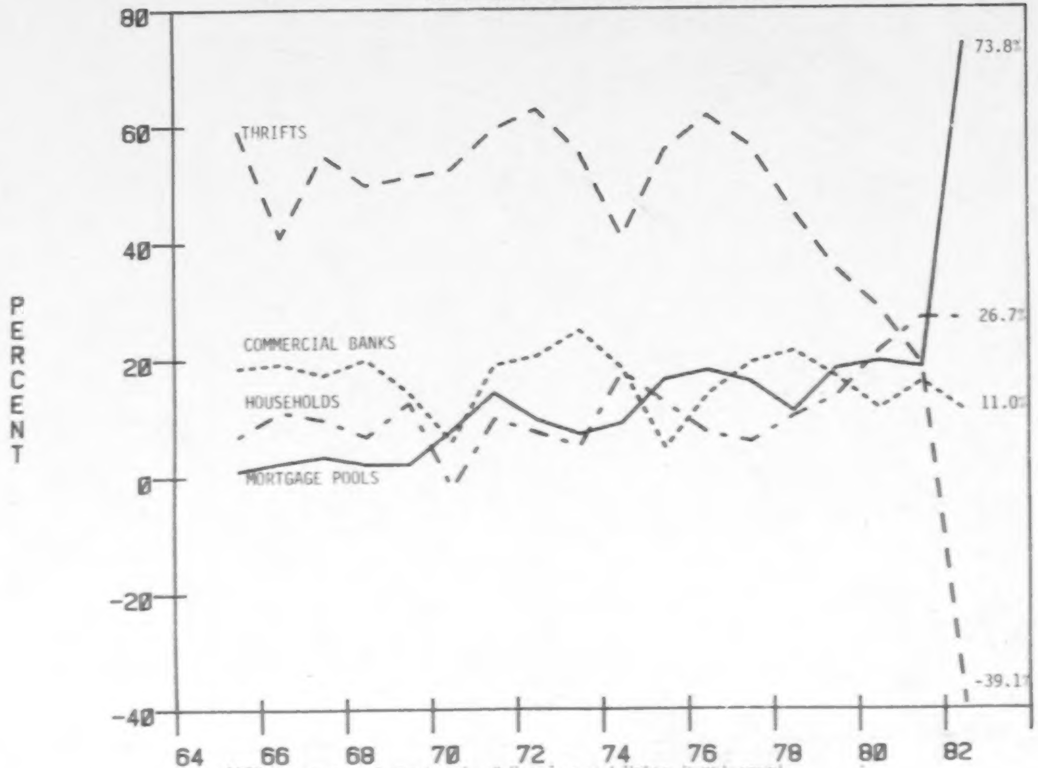
HOLDINGS OF THE MORTGAGE POOLS



June 1983 Source: Federal Reserve Board.

CHART V

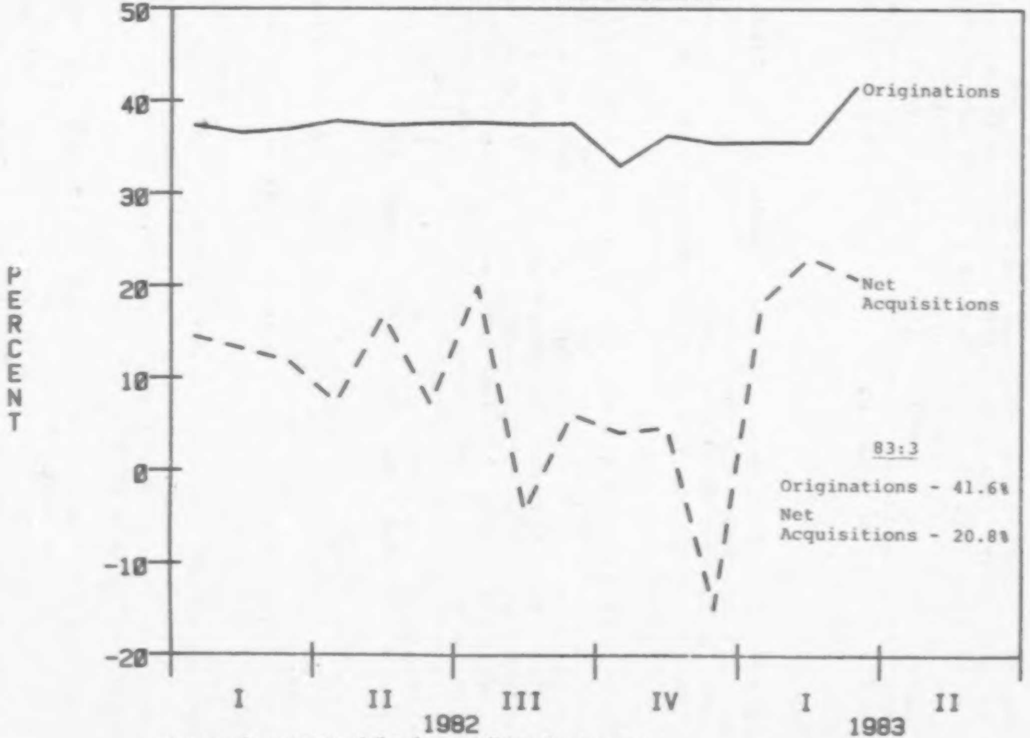
SHARE OF FUNDS PROVIDED TO FINANCE HOME MORTGAGES



June 1983 Source: Department of Housing and Urban Development.

CHART VI

SHARE OF ORIGINATIONS AND NET ACQUISITIONS OF MORTGAGES BY SAVINGS AND LOAN INSTITUTIONS (% OF TOTAL DOLLARS)



Source: Department of Housing and Urban Development.

June 1983

portfolios. Considering what has happened in the past, only suicidal thrifts would borrow short and invest long. Now the thrifts make their profit by earning origination and servicing fees on the packaged loans they sell to the pools. The only mortgages that it makes sense for the thrifts to hold are those with variable rates whose maturities can be matched with those of the funds that support them.

The Problem

One of the basic problems with the fixed rate mortgage in the past has been the homeowners' "heads I win, tails you lose" advantage over the lenders. Without a prepayment penalty, the borrower on a fixed rate loan was in great shape!

If the market rate on new mortgages went up, the borrower could hold on to his old low rate loan. The thrift lost the opportunity to invest in funds at a higher rate. When rates fell, however, he could repay his loan without penalty, forcing the thrift to reinvest the funds at the new lower rate. Thus for the homeowner there is no upside risk and significant downside benefit. For the lender there is loss of opportunity on the upside and lower revenues when rates decline. In this situation the borrower never loses and the lender never wins.

Prior to the advent of deregulation, the thrift industry did not bear the burden of this risk, however. Because they borrowed at regulated rates, it was the smaller saver who subsidized the borrower and suffered the consequences of lower returns to the lender. The smaller saver had trouble avoiding this loss, however, because before the advent of money market funds he had few alternatives for investing his funds. He had to accept the thrifts' rates, which reflected lower revenues due to unrestricted prepayment.

Now, however, it is the investor in mortgage pools who calls the tune on long-term mortgage rates, and he will not bear the cost of losses due to prepayment. Rather, the pool investor requires a higher yield on contracts that might prepay and result in yields below the original.

The greater the probability of prepayment, the greater the risk premium on the security. Chart VII shows the change in the yields for three GNMA securities as interest rates fell. The spread between the yields on GNMA 8's and GNMA 14's rose from 37 basis points in January 1982 to 189 basis points in June of this year, an increase of over 150 basis points. Meanwhile the spread versus GNMA 11's rose only from 27 basis points to 62. This clearly reflects the fact that GNMA 14's are expected to prepay quite rapidly, especially now with rates well below 14% for new mortgages. The growing spread between 8's and 11's reflects the fact that 11's will prepay sooner as rates decline, but the spread is still fairly narrow because we have not yet reached rates which would trigger heavy prepayment of the bond.

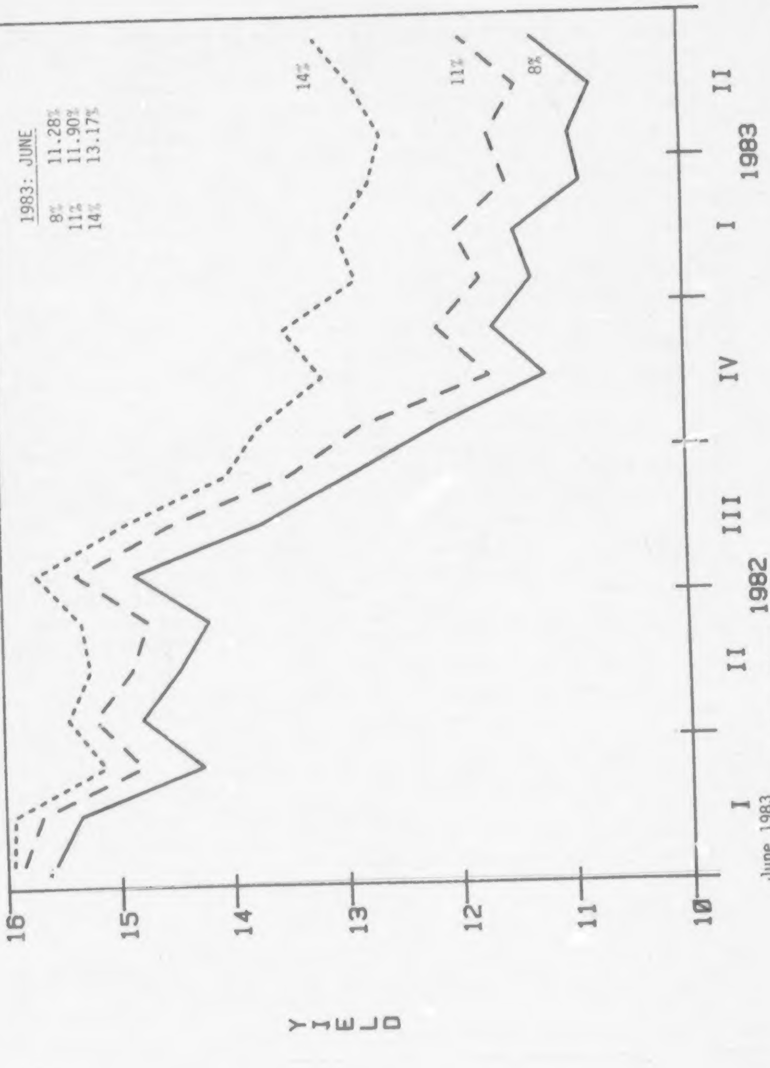
Chart VII illustrates that it is not the investors but the mortgagees who bear the higher cost of funds necessary to compensate for losses due to prepayment. Therefore, it is those homeowners who do not prepay who are essentially subsidizing those who do. The homeowner who wants a fixed rate mortgage in the current marketplace can get one, but only at a higher interest rate than there would be if only those who prepaid bore the cost of their action. Of course, this is especially true in times when investors expect mortgage rates to fall, and hence expect prepayments to be considerable. We have seen that fear of prepayment can add over 150 basis points to the cost of loans if the market perceives that rates are going to fall. In today's marketplace where disinflation is a very real force this means borrowers may be paying an additional $1.875 Billion in interest on the roughly $125 Billion in single family mortgages which will be made this year.

The Solution

In order to increase the efficiency of the market and reduce interest rates, a prepayment adjustment which affects only those who prepay is needed. This prepayment adjustment would make the prepayer bear the full cost of his action.

CHART VII

YIELDS ON GNMA SECURITIES (8%, 11%, AND 14% BONDS)



June 1983
Source: The New York Times.

In order to create an effective and long-lasting solution, we suggest allowing the market to set the fair value of the prepayment adjustment. It might be tempting to use a formula that would reflect the market, or at least the current market conditions. The problem is that markets can change tremendously, making any such formula obsolete. Years ago, controlling passbook saving rates by regulation seemed like a perfectly sensible way to keep the thrift industry from killing itself through competition. Few then dreamed, however, that interest rate increases would be so huge as to force the development of alternative investment vehicles for savers and to threaten the existence of the thrift industry. In the future, tying a prepayment adjustment directly to the open market is probably the only safe bet.

How would it work? The mortgage prepayer would essentially become a bond issuer who calls his outstanding obligation at the current market price. For example, if a 30 year bond had been issued at par 5 years ago when rates were 10%, it would now be selling for $843.13 if current rates are 12%. The issuer could buy it back at $843.13 a discount of $156.87 from the original issue price. If rates fall to 8% in another 5 years, the bond price would rise to $1196.35, and the issuer would have to pay a premium of $196.35 to buy his bond back from the market.

Our proposed prepayment adjustment would work just the same for the mortgage prepayer. By taking out a mortgage, the home owner has taken on the obligation to pay a fixed amount based on the interest rate plus principal repayment for the life of the loan. If he wishes to prepay his debt he does not merely repay his outstanding principal, but must "buy back his bond." In effect, he must provide the lender with an amount of capital which, when reinvested at current market rates, will produce the same level of income for the remaining period of his original obligation. In other words, he must pay the discounted present value of the remaining payment stream at current interest rates.

For example, if a homeowner borrows $100,000 at 12½% for 30 years he is obligated to pay $1067.26/mo. for the next 30 years. If after 5 years he wishes to repay his debt and rates have fallen to 12% he does not simple repay the outstanding balance of $97,881.96. He must, under our proposal, provide his lender with a sum sufficient to produce $1067.26/mo. for 25 years at 12% interest. That amount would be $101,332.66. This is $3450.70 more than his outstanding balance or a prepayment penalty of 3.53% of the outstanding balance.

Table IV shows the prepayment penalty varies depending on how much the interest rate has changed and how much longer the mortgage has to run. The greater the differential between the original contract rate and the current market rate, the larger the prepayment penalty. Similarly, the longer the outstanding debt has to run, the larger the prepayment penalty. Both the borrower and the lender should be aware that when rates drop sharply the principal plus prepayment fee could exceed the total equity in the home. Later in this paper we will discuss the possibility of avoiding this problem by placing a cap on the maximum prepayment fee.

This market determined fee could be applied to partial repayments as well as complete redemption of the debt. If rates had fallen the partial prepayment would reduce the outstanding principal, but at less than a dollar for dollar rate. For example, if in the situation described above a prepayment of $10,000 were made it would reduce the principal by only $9659.04. The remaining $340.96, which represents 3.53% of the repaid principal, is a prepayment fee.

This market-determined adjustment should not be limited to penalties for prepayment when rates have fallen. If a homeowner chooses to repay his debt ahead of time and interest rates have risen he should receive a bonus from his lender. He "buys back his bond" at a discount price. The bonus reflects the fact that the lender can now reinvest the funds and earn a greater return than in the original contract. Since the homeowner only needs to replace the income stream to fulfill his obligation to the lender, he only has to pay the discounted present value of his monthly payment for the remainder of the loan's life at the current market rate.

TABLE IV

PREPAYMENT FEE ON 30 YEAR
12% MORTGAGE ORIGINAL BALANCE $100,000

(Rounded To Nearest Dollar)

Age of Mortgage	Current Market Rate			Principal Remaining
	12%	11½%	10½%	
1 year	$3706	$7662	$16415	$99675
2 year	3650	7541	16135	99307
3 year	3589	7411	15832	98889
5 year	3451	7119	15153	97882
10 year	2991	6141	12962	93937
15 year	2334	4769	9958	36592

	Fee As A Percent Of Outstanding Balance		
1 year	3.71%	7.69%	16.47%
2 year	3.68	7.59	16.25
3 year	3.63	7.49	16.01
5 year	3.53	7.27	15.48
10 year	3.18	6.53	13.80
15 year	2.70	5.50	11.50

Source: A. Gary Shilling & Company

June 1983

For example, if the homeowner with the 12½% 30 year mortgage wants to repay his debt after five years and interest rates have risen to 13% he does not have to provide the full $97,881.96 outstanding on his loan. He pays only $94,629.07. The lender can reinvest this at 13% and it will provide the same $1067.26/mo. the homeowner has been paying for the next 25 years. In effect, the lender has paid a $3252.89 bonus, or 3.32% of the outstanding balance, in return for prepayment of the loan. Table V outlines the range of potential bonuses in the same fashion Table IV indicated potential penalties.

Once again if the homeowner makes only a partial prepayment the market rate adjustment still applies. Only now since rates have risen he receives a bonus. Using our example from above: assuming rates rise to 13% and the homeowner prepays $10,000, he would actually reduce his outstanding principal by $10,332. The additional $332 represents the prepayment bonus for early retirement of debt. This technique would be particularly rewarding for both borrower and lender in a market where rates were generally rising. The borrower would earn bonuses by prepaying whenever he had funds available and the lender would benefit from the opportunity to reinvest, perhaps in variable rate assets, in a market where yields were increasing.

It should again be emphasized that only the mortgage prepayers are affected by this prepayment adjustment. And they may win or lose, depending on interest rate movements since their mortgages were issued. Furthermore, those gains or losses cannot be known in advance. Those homeowners who do not prepay, on the other hand, continue to be absolutely assured that their repayment schedule will remain unaltered. Again, it's exactly like the early redemption of bonds. The issuers may pay a premium or receive a discount for buying back his bonds before maturity, and that difference from par cannot be ascertained ahead of time. The issuer who redeems only at maturity, however, has a fixed and certain obligation.

TABLE V

PREPAYMENT BONUS ON 30 YEAR 12% MORTGAGE ORIGINAL BALANCE $100,000

(Rounded To Nearest Dollar)

Age of Mortgage	Current Market Rate			Principal Remaining
	13%	13½%	14½%	
1 year	$3476	$6741	$12701	$99675
2 year	3428	6650	12542	99307
3 year	3374	6551	12367	98889
5 year	3253	6322	11962	97882
10 year	2841	5542	10557	93937
15 year	2239	4388	8433	86592

	Fee As A Percent Of Outstanding Balance		
1 year	3.49%	6.76%	12.74%
2 year	3.45	6.67	12.63
3 year	3.41	6.62	12.51
5 year	3.32	6.46	12.22
10 year	3.02	5.90	11.24
15 year	2.59	5.07	9.74

Source: A. Gary Shilling & Company.

June 1983

Prepayment Adjustment Means Lower Mortgage Rates

The net effect of a prepayment adjustment on new -- but obviously not on old -- mortgages would be lower long-term mortgage rates. As noted above, had the GNMA 14's been issued with our prepayment adjustment, they probably would yield 150 basis points less today. This adjustment would certainly benefit mortgage borrowers who don't refinance, especially when their mortgages are issued in times when investors expect interest rates to fall and therefore would demand large interest rate premiums if prepayment adjustments were not included. Those who prepay could be the losers if mortgage rates fall, but could gain if rates rise. Thrifts that, contrary to our best judgment, continue to hold long-term mortgages that are backed by short-term liabilities would also gain. Their mortgage rates and revenue might be somewhat lower, but they would not be plagued by the prepayment losses that they suffered when mortgage borrowers engaged in the "heads I win, tails you lose" game.

Finally, and perhaps most important, the lower long-term mortgage rates promoted by our proposed prepayment adjustment would enlarge the housing market by making homes more affordable. It is obvious today that the key to unleashing the tremendous pent-up housing demand in this country is the solution to the affordability issue.

Today, at 13% rates on conventional mortgages, a family with median income that buys a medium-priced house with 25% down and a 30-year mortgage commits 50.9% of its after-tax income to the monthly mortgage payment alone. Taxes, insurance, utilities, and other homeowner costs are extra. In the more normal times of the late 1960's the number was 25%. Each 1% decline in long-term mortgage rates reduces the share of family income consumed by the monthly payment by 7%. Furthermore, the Census Bureau estimates that each 1% decline in the mortgage rates makes housing affordable to another 100,000 families.

Obviously, any measure such as a prepayment adjustment that reduces long-term mortgage rates is a step in the direction of increasing the affordability of housing.

Special Cases

Of course, in applying a prepayment adjustment, thrift institutions may want to take account of special cases. Fairness and equity certainly indicate that people who are simply speculating in housing should no longer enjoy the privilege of having no prepayment penalty. For hardship cases, such as people who are transferred due to job location changes, a thrift institution may choose to waive or reduce a prepayment adjustment.

It would also be possible to structure an option under which the prepayment adjustment in either direction would be limited. Some mortgage borrowers, for example, might want to limit the premium they would need to pay to "buy back their bond" to 5%. At the same time they might be willing to limit their potential gains to the same 5% figure. Thrifts could accommodate such desires but perhaps would choose to do so at higher initial mortgage rates.

Conclusion

With the deregulation of the thrift institution's liability side, the cost of funds has increased and the maturity of portfolios has shortened considerably. This leaves the thrifts with two logical choices: either to issue adjustable rate mortgages whose rate adjustments are linked to the maturity of the supporting funds, or to issue long term mortgages -- which many borrowers still prefer -- to the mortgage pools.

Without a prepayment adjustment, the interest rates demanded by investors in mortgage pools extract a premium to offset the high likelihood that mortgages will be prepaid before maturity in periods of interest rate declines. Consequently, the long term homeowner who does not prepay his mortgage is paying a higher than necessary rate and subsidizing those who do prepay.

This problem could be easily solved by regulatory changes or legislation that would allow any single family mortgage lender to include a prepayment adjustment in new mortgage contracts. With our proposed adjustment, the mortgage prepayers would be in the same position as bond issuers who buy back their obligations in the open market before maturity. The premium paid or the discount received to "buy back their bond" would be strictly determined by then-current mortgage rate levels.

This prepayment mechanism would shift the risk entirely to the prepayer. Long-term mortgage borrowers would enjoy lower mortgage rates in return for adhering steadfastly to their repayment schedules. Thrift institutions that retain long-term mortgages in their portfolios would no longer suffer the revenue losses that come from penalty-free prepayment. Most importantly, long-term mortgage rates would tend to be lower, therefore making an important contribution toward solving the tremendous housing affordability issue that now confronts the nation.

ADDENDUM

In the main body of this paper we have concentrated on a suggestion for improving the fixed rate mortgage primarily because it is still prefered by most borrowers and, thus, remains the dominant force in the market place. As we mentioned, however, the thrifts would prefer to develop effective ARM's so they could match the maturities of their liabilities to the adjustment period of their loans and avoided interest rate risk. It is important to note, however, that this initial matching of rate sensitivities does not guarantee the thrift immunization from interest rate risk for the life of the mortgage. A thrift can still run into trouble if at the end of an adjustment it does not have enough deposits with a maturity equal to the adjustment period of the mortgages being rolled over.

For example, if a thrift issued mortgages with six month adjustments, as was quite popular last year, they would need a continuing pool of six month deposits which could be matched against the mortgage pool for the next 30 years. Unfortunately, any number of changes in the capital markets might shift these funds into different assets leaving the bank with a mismatch in rate sensitivities. The exodus of funds from 6 month CD's into MMDA's is one example. A shift in the yield curve could also alter the investors maturity preference.

To counter the inevitable movement of funds the thrifts must be able to freely set the rate on deposits of all maturities. The funds will naturally move toward the maturities with the highest yields. Yet even this is not enough since the rate required to attract funds into deposits of a given maturity may be so high that the homeowner with a mortgage backed by those funds would not wish to continue borrowing at that rate.

As a solution to these problems we propose the development of an ARM which allows the borrower and lender to renegotiate all of the terms of the contract at the end of each adjustment period. For example, at the end of an initial six month adjustment period the thrift could offer his borrower the option of several different adjustment periods (six months, one year, five years, etc.) each with a rate based on the thrifts current cost of funds in that category of deposits. The borrower would then decide which rate suited him best.

Furthermore, the borrower could adjust his amortization schedule to reflect any changes in his financial position. In essence the only commitment in the contract, beyond the original terms, will be the obligation of the thrift to guarantee funds will be available to his borrowers at each renegotiation point. The consumer's preferences and capital markets would determine everything else.

This contract is the ultimate in the application of free market principals to mortgage lending. It is completely fair to borrowers and lenders in that no decisions are forced on them. In this situation the thrift would act as a pure intermediary between borrowers and lenders adjusting rates on deposits and mortgages only when his portfolio's asset and liability maturities were not matched. Competition with other thrifts and between thrifts and other lenders would determine the spread between the borrowing and lending rates. It would also eliminate the least efficient intermediaries. Allowing the free market to work in this way would effectively reduce interest rates to borrowers while maintaining fair returns to depositors.

STATEMENT OF PHILIP COLDWELL, COLDWELL FINANCIAL CONSULTING, WASHINGTON, D.C.

Mr. COLDWELL. Mr. Chairman, I'm delighted to be here and in line with the disclosures formerly made by other speakers, I will tell you that in my post-regulatory environment I have been consulted. I'm consulted on a variety of things, including money market mutual funds and maybe that qualifies my discussion.

GROWING UNCERTAINTY IN THE FINANCIAL INDUSTRY

I have watched with great interest the changes taking place in the financial industry as deregulation has fostered increased activities, broader authorities, improved competition, and I believe better services to the public. But I've also watched with considerable concern the growing uncertainty in this industry, both from the individual standpoint of the general public and from the firm's standpoint.

It seems to me today we face a rather confusing situation in an overall look at this package. Banks and nonbanks are challenging each other's lines of business. Individual firms are somewhat uncertain as to their future, and the general public is being bombarded with a whole variety of advertising, and I think it's becoming somewhat confused.

There seems to be a growing threat to some of the dual banking system arrangements we've had in the past, as the large banks establish loans production offices, edge accounts and electronic transfer capabilities. On the other hand, the States are leading the Federal Government toward greater diversification and some broader activities provided.

Our regulatory structure, it seems to me, is crumbling under the shifts in the other fields of endeavor with pressure for deregulation and, more importantly, the uncertainties of who's going to be the regulatory authority, if we have one at all, over the interstate and merging industries. A carefully crafted balance between the State and Federal authority is coming apart as State legislation leads in this new interstate activity and the Federal agencies debate the direction of change to be supported.

I am not at all surprised by some of the developing trends because I think they were inevitable with the growth of the Nation and the technological capabilities which have welded the system into a single credit market. But these trends need to be carefully appraised and watched to ascertain the balance of benefits and risks, certainly with regard to the future of the industry and the depositing public. We can't turn back, in my opinion, and depositors have already found that they can obtain market rates of interest on their savings. They don't have to subsidize borrowers any more, and the banks have found their protected environment is giving way to a new pattern of competition from both other depository institutions and other firms.

But unless we rationalize this industry, I have a feeling that we're going to face a financial unguided missile, without direction, without protection for depositors, and without sufficient stability to permit the orderly development of a national fiscal policy.

In order to rationalize the industry, it seems to me guidance must be given on the following questions:

First. What is a bank? Is the business of banking sufficiently distinct to warrant different treatment?

Second. To what extent can market discipline be relied upon to substitute for regulation?

Third. Wherein lies the best public policy for the benefit of the depositors, borrowers, stockholders, employees and of course the community. Are these in conflict with each other or possibly with the policy which is best for the Nation as a whole?

Fourth. Are we willing to broaden the industry's reach to true interstate operations with freedom to merge and consolidate without anything but antitrust regulation?

Answers to these questions are both difficult and uncertain, but I have some opinions on them. It seems to me that banks are special institutions. They're expected to handle their responsibilities in a safe and prudent manner. They're expected to handle the public policy needs of the Nation. Perhaps we have too many restrictions and probably too much in the way of regulation, but I continue to maintain that we should provide some guidance and surveillance and in some areas control over the industry.

Some observers and public officials seem willing to trust the marketplace to force disclosure and use that to discipline the banks. But over the past 30 years when I was in the regulatory business, the history of those years says to me that we will have a jungle of bank failures, an excessive concentration in the industry and an unpredictable pattern of credit provision and industry practices. Others seem willing to allow banks to engage in a variety of other businesses if those are placed in subsidiaries under an overall corporate roof, but I see such a subsidiary route as a snare and a delusion because we have been unable to separate bank safety from that of the subsidiaries and because the corporate umbrella is still responsible for the activities of the subsidiary.

From my perspective, we seem to be in danger of forgetting the lessons of history and regulation. Overconcentration leads to excesses by a few to the detriment of the many, that joining credit granting institutions with credit using companies often leads to abuses of insider loans, unequal access to credit, and compromised financial institutions. Past history in this country and present conditions abroad raise a huge warning flag against broadening financial industry ownership into other industries. If we are to avoid the problems, then I think we should be establishing guidance as to its parameters of authority, business, power to grow by merger or consolidation, and means to protect the public interest.

CONGRESS FACES CHALLENGE OF PROVIDING GUIDANCE

It seems to me that Congress faces several choices to meet the challenge of providing guidance to this industry. First, of course, it can do nothing but allow the continued erosion, watch developments, and then ratify the ultimate structure. Second, it could establish a master plan, but that presumes there's political consensus for action and for a particular action. Third, I think Congress could demand a halt to further change and declare a moratorium until a political consensus is reached. Finally, Congress could take a few first steps while it surveys the developments and then determine if other measures are needed. The strong industry turf battles this general problem will engender will slow congressional action. A moratorium, to me, is undesirable but it may be necessary to halt the erosion. Time is working against a rationalization of the industry unless you're looking for a fully open industry with little regulation and no legislative prohibition. I would counsel against such a program.

If an overall pattern for future change is not readily available and a wide open industry creates unacceptable risks, as it does to me, then what should be done? First, I suggest that Congress decide what is a bank and whose laws are applicable.

Second, I would urge the Congress to establish Federal preeminence in the laws governing bank authorities and ownership. It is inconceivable to me that we would tolerate competition in laxity among the States and let that create our national banking policy. The clear route to such a Federal preeminence is the withdrawal of Federal insurance for transgressors.

Finally, I think we should equalize the authorities within the various units of the financial industry.

With regard to interstate banking, I suggest that it be allowed to continue, perhaps even directly permitted, but only with some limitations as to size of the resulting institutions. I suggest a limitation not because of any desire to penalize, but because the failure of a small bank is not a national event, but the failure of a large bank, especially with interstate and international operations, could create a national crisis. The larger we permit our financial institutions to develop relative to the national total and the greater the concentration of financial power, the more exposure we assume in being faced with a potential public bailout.

I close with only two further words of advice. First, it seems to me the haphazard jerry-built financial structure which has developed creates risks to the dangers of safety and to our reliance on a few overly powerful institutions.

Second, I hope Congress will carefully consider the impact of the financial industry structure, authorities, and participants on the ability of the central bank to develop and maintain an appropriate monetary policy. If participants include regulated and nonregulated firms, it will be quite difficult to establish the sources of credit and control the degree of central bank provision of reserves necessary for stable and sustainable growth. Similarly, it's going to be very hard to monitor this industry if reports are required from only a few participants which have an eroding share of the Nation's total financial transactions. I hope you will watch that with great care.

Thank you, Mr. Chairman.

[The complete statement follows:]

STATEMENT BY DR. PHILIP E. COLDWELL, CHAIRMAN, COLDWELL FINANCIAL CONSULTING SERVICES

It is a pleasure to be with you today and to have the opportunity to comment on the recent developments in the financial industry and their implications on the future. I have spent most of my working life with the Federal Reserve System - first as an officer and then President of the Federal Reserve Bank of Dallas and finally as a member of the Board of Governors. In the course of those nearly thirty years, I was exposed to many of the problems and successes of the financial industry, to the detailed operations of the Federal Reserve Banks, and to the interindustry differences and inequities of regulations and operations. I have experienced the frustrations of regulatory controls gone awry, the disappointments with trusted bankers who strayed from the prudent path, and the joy of seeing successful financial institutions provide excellent credit and operational services. As a current member of the boards of directors and trustees of several money market mutual funds, I have seen the rewards to investors seeking market rates of interest on their investable funds.

Over the past few years I have watched with great interest the rapid changes taking place in the financial industry as deregulation fostered increased concentration, broader authorities for the firms, and improved competition and better services for the public. But I have also seen the growing uncertainty and unrest among financial firms and even the general public as to the future of the individual units and the prospects for the industry as well. To some degree, Congress has contributed to this developing unrest in the industry by permitting changes in the roles of the various segments of the industry such as enlarging the authorities of the thrift units without withdrawal of their special powers for interstate branching and real estate development. Further, Congress has watched with little guidance when the non bank firms entered the business of banking and banks began to enter other businesses. Erosion of geographic and industry limitations have proceeded with very few challenges from the Congress or even some of the regulators. The developing structural pattern is the subject of this hearing.

Today we face a confusing situation where banks and non banks seek to challenge each other in the banking and securities businesses, where the lines of banking and commerce are blurred almost beyond distinction, and where individual firms fear for their future. The general public is bombarded with advertising claims of full service financial programs, high interest rates for deposit accounts, a growing range of new investment accounts, and other services from both the traditional depository institutions and the newer non depository but financial firms. There is a growing threat to the dual banking system from the interstate operations of large banks as they establish Loan Production Offices, Edge Act companies, and electronic transfer capabilities. On the other hand, we see the states leading in the movement toward greater diversification and broader authority for banks and other financial firms. Our regulatory structure at both the state and federal level is crumbling under the weight of unguided missile without direction, without protection for depositors, and without sufficient stability to permit the orderly development of national fiscal and monetary policies.

In order to rationalize the industry, it seems to me that guidance must be given on the following questions:

1. Is the business of banking sufficiently distinct to warrant a different treatment from other industries by defining its authorities and responsibilities and retaining specialized limitations on its activities? If so, then what shall be the definition of a bank and the banking business and what protections and limitations should be imposed?
2. To what extent can market discipline be relied upon to substitute for regulation by chartering, examination, supervision, insurance, or other limitations? Is survival of the fittest with the concentration of financial power the best course of policy for the nation?
3. Wherein lies the best public policy course for the benefit of the depositors, borrowers, stockholders, and employees of the financial institutions and the communities they serve. Are these in conflict with one another or with the best policy for the Nation as a whole?
4. Are we willing to broaden the industry's reach to true interstate operations with freedom to merge and consolidate with only the broad anti-trust laws as protection?

Answers to these questions are both difficult and uncertain but, generated by my past experiences, I have some opinions. I think that banks are special institutions with a special set of responsibilities to maintain the prudent and safe methods of doing business in order to assure the safety of the depositors funds and to meet the public policy needs of the Nation in developing the best fiscal and monetary policies attainable. Perhaps we have too many restrictions and too many regulations, but I think we should maintain continued surveillance and in some areas control over the industry. From my past experience as a bank regulator, I have seen greed, poor management, errors in reaching for size, insider transactions, and other questionable practices which lead me to be unwilling to trust to the public spirited nature of bankers or to an open free enterprise system for the safety of the financial industry or my personal funds in it.

Some observers and public officials seem willing to trust the market place to force disclosure which might discipline the banks but I see a jungle of bank failures, an excessive concentration in the industry, and an unpredictable pattern of credit provision and industry practices. Others seem willing to allow banks to engage in a variety of other businesses if those are placed in subsidiaries under an overall corporate roof, but I see such a subsidiary route as a snare and a delusion because we have been unable to separate bank safety from that of the subsidiaries and because the corporate umbrella is still responsible for the debts, assets, capital, and activities of each unit in the corporation.

From my perspective, we seem to be in danger of forgetting the lessons of history and regulation. Briefly stated these include: that overconcentration leads to excesses by a few to the detriment of the many, that joining credit granting institutions with credit using companies often leads to abuses of insider loans, unequal access to credit, and compromised financial institutions suffering from the losses in their non bank industry units, and that specialized financial institutions are needed to meet the publicly perceived requirements for credit to housing, farming, and other similar endeavors. Past history in this country and present conditions in other countries raise a huge warning flag against broadening financial industry ownership into other industries. In a number of countries such a merger has led to the nationalization of banks as banks became exposed to losses from other industries. Similarly overconcentration of financial power has led to excessive political power. If we are to avoid the problems of the past we should be estabishing guidance to the industry as to its parameters of authority, business, power to grow by merger or consolidation, and means to protect the public interest.

It seems to me that Congress faces several choices to meet the challenge of providing guidance to this industry. First, of course it can do nothing but observe the developments, permit continued erosion of the interstate and industry limits and then ratify the ultimate structure. Second Congress could establish a master plan to guide the entire industry development but this would presume that there is a political concensus for action and for a particular action. Third Congress could demand a halt to further change by a moratorium until a political concensus is reached, but this presumes a short period of debate while the leaders enjoy a competitive advantage over their slower rivals. Fourth, Congress could take some first steps while it surveys the developments and then determine if other measures are needed. Given the strong industry turf battles this general problem will engender, the divided position of the banking industry, and the pressure for equal regulatory and legislative treatment of firms doing like business I consider it unlikely that Congress could reach an overall solution this year. A moratorium is undesirable if it relieves the pressure for congressional action but may be needed to halt the erosion. Time is working against a rationalization of the industry unless one seeks a fully open industry with little regulation and virtually no legislative prohibitions. I would counsel against such a program.

If an overall pattern for future change is not readily available and a wide open industry creates unacceptable risks, then what should be done? First, I suggest that Congress immediately address the definitional question of what is a bank, including savings and loan and credit unions. Such a determination would establish who is subject to the laws and regulations applicable to banks. To me a bank is any institution holding a federal or state charter which accepts the public's deposits and makes loans. Under this definition a bank is not a firm which accepts funds only for investment.

Secondly, I would urge Congress to establish Federal preeminence in the laws governing bank authorities and ownership. It is inconceivable to me that we would tolerate competition in laxity among the states and let that create our national banking policy. The clear route to such a Federal preeminence is the withdrawal of federal insurance for transgressors.

Finally to equalize bank and thrift positions I urge Congress to phase in comparable authorities. If savings and loans and credit unions are to be banks then I would strongly suggest that authority for real estate development be withdrawn from the thrift units.

With regard to interstate banking I suggest that it be allowed to continue to evolve and perhaps be specifically permitted but only with limitations on the size of the resulting institutions and insistence upon adequate capitalization. It does not seem unreasonable to me that banking organizations with 5% of the Nation's domestic deposits be prohibited from further acquisitions. Nor would I consider it an unjustifiable limitation to bar nonbank acquisitions by banking organizations which already have a similar presence in the particular non bank industry.

I suggest these limitations because failure of a small bank is not a national event but failure of such a large bank especially with interstate and international operations could create a national crisis. The larger we permit our financial institutions to develop relative to the national total and the greater the concentration of financial power, the more exposure we assume in being faced with a potential public bail-out or even nationalization.

I close with only two further words of advice. First, the haphazard jerry-built financial structure now developing creates risks both in relation to the dangers of safety and to our reliance on a few overly powerful institutions. We should not attempt to go back to the strait-jacketed industry of the past but we should not allow the evolvement of an industry structure which replaces over regulation and unnecessary limitations with a dangerous concentration of financial power. I think long run public benefits from increased competition are more likely to be available without centralized control or the risks of diversified industrial ownership.

Secondly, I urge Congress to consider carefully the impact of the financial industry structure, authorities, and participants upon the ability of our central bank to develop and maintain an appropriate monetary policy. The Federal Reserve will be faced with new and unsettling complications from a financial industry which includes other industry ownership. If participants include regulated and non-regulated firms it will be quite difficult to establish the sources of credit and control the degree of central bank provision of reserves necessary for stable sustainable growth. Similarly, it will be hard to monitor or influence the pattern of credit usage in a financial industry where reporting is required of a diminishing number of participants which have an eroding share of the Nation's total financial transactions. In my opinion we run a clear risk of severely compromising the only recently effective instrument of national economic and financial influence toward less inflationary and sustainable growth.

The **Chairman**. Thank you very much.

We will recess the committee for about 15 minutes while we go vote and if all of you, with your vast experience as former regulators now in the private sector, what I would like you to do in that 10 or 15 minutes is all get together and come up with a detailed set of specific recommendations that will solve all of these problems for us.

[Recess.]

The **Chairman**. The committee will come to order. First, I would announce that the tax cut is intact and the Democrats are all very happy. They got the best of all worlds. They got to vote against it and keep the money. [Laughter.]

I hope you are all prepared to now present to the committee your unanimous recommendations for the solutions for all of these problems and we could probably start with what a bank should be and whoever would like to be the spokesman for the group.

Mr. **Marston**. He's the lobbyist. We've nominated you, Jim.

The **Chairman**. Mr. Sommer, please proceed.

STATEMENT OF A. A. SOMMER, JR., MORGAN, LEWIS & BOCKIUS, WASHINGTON, D.C.

Mr. **Sommer**. Mr. Chairman, thank you very much for the opportunity to be here this morning. I have a disclosure to make similar to some of those made by others but not quite as formidable. The only influence that has been brought to bear on my thinking on this subject occurred when one of my associates found out yesterday that I was going to be testifying. She has a desk loaded with applications for the acquisition of savings and loans and she said, "For heaven's sake, tell them not to adopt a moratorium because otherwise I don't know what I'll be doing." I'm not going to address that issue so I can't be said to be prejudiced by her remarks.

I think the discussion you are leading, Senator Garn, by holding these hearings is extremely important and is an extremely responsible way to go about dealing with these problems. I think by gathering all the opinions and the expressions of concern and suggestions for solutions as you are doing certainly will lead, I think, to responsible legislation in the Congress.

It is a great privilege for us to participate in this discussion which I think has such tremendous importance. My children and grandchildren I think will have their lives deeply influenced by whatever comes out of these hearings.

You've heard a range of suggestions which have run all the way from minor tinkering, in fact even less than that—leave the status quo the way it is—through suggestions that there should be some modest reshuffling of responsibilities and roles in the regulatory arena, to a proposal made by my very close friend and former SEC Commissioner, Steve Freedman, that perhaps there should be one financial regulator because the financial instruments today have become simply points on a broad spectrum and it's difficult to figure where one stops and the next one leads off.

I do not think that is politically or practically feasible at this time, although I suspect the day may come when some serious consideration will be given to it.

However, I think that that sort of notion leads me to another suggestion that perhaps is rather novel. It may be seen by some as a suggestion that in this age of rampant deregulation we adopt another level of regulation, but I would not certainly construe it that way and I hope that you would not either.

As we look at the structure that we have developed and worked with in the past and we realize how creaky it has become, it seems to me we should not be surprised that the joints creak a little bit, but rather should praise the fact that Congress in 1933 established a structure that permitted our economy to develop as it has, enabling us to finance three wars, and to become the financial savior, if you will, of the entire Western world. I think that was a great accomplishment and I would hope that what this committee and the Congress does and what the President does in reworking these laws will have a similar durability.

However, as Alvin Toffler, in his book a few years ago, "Future Shock" indicated, the ever-present phenomenon that we confront throughout our lives is change, and he predicted at that time that, if anything, the pace of change was going to accelerate and people who survived intellectually, physically, and emotionally would be those with the ability to adapt to it and to do so quickly. It seems to be the very fact of these hearings is an indication of the correctness of his assessment.

However, I do not think the Congress will be able to legislate in a fashion that will anticipate all the changes in the years to come in the financial world.

UNEVENNESSES IN THE PLAYING FIELD

That leads me then to the thought that perhaps in its consideration of these matters Congress should build into whatever solutions it develops some sort of mechanism for dealing with future changes as they occur. I don't think there's any dispute that there are unevennesses on the playing field upon which these events are happening. I don't think there is any dispute that there are loopholes and that imaginative entrepreneurs and their lawyers have been able to take advantage of them. I don't think there is any assurance, however, that whatever comes out of the legislative process at this time will anticipate all of the possible loopholes that will be found in the future by imaginative entrepreneurs and lawyers, and I don't think Congress can anticipate all the bumps that may develop on the playing field in the years to come.

I would therefore make a suggestion that I think may have some possibility of giving flexibility to the regulatory scheme that develops so that it will take into account the ongoing change, and I would commend it to you.

It seems to me that there is a need to provide a mechanism by which, on an ongoing basis, several things may be accomplished. We have seen in the past a number of phenomena arise. We have seen new instruments for financing, new ways of configuring institutions, new types of financial services develop, and it seems to me we should have some means by which these can be dealt with in the future, if they pose, or begin to pose, the sort of problems that are presently confronting us.

NEED OF A MECHANISM FOR FAIR AND EQUAL TREATMENT

What would I suggest? It seems to me there ought to be in place some kind of a mechanism, some kind of an institution, an agency, an official in the Government, that would have the means of continuously adjusting the responsibilities of the various regulatory agencies, resolving disputes over turf, avoiding conflicting interpretations of statutory language and in general assuring that the regulatory agencies move in greater concert than they have in the past to assure that there is continuing fair and equal treatment of everyone who plays in the game.

Now what would this agency or officer be empowered to do? It seems to me that for one thing it might have the authority to resolve conflicting interpretations of law. For instance, it might have the power to determine, if it were in existence now, whether the interpretation of the Fed or that of the Comptroller of the Currency with regard to what a bank is and the way in which investment banks may relate to banks or nonbanks is correct and good policy, to resolve that question in a definitive fashion so that we would have a unified Federal policy on it.

It seems to me that it could have the power to resolve questions of disputed jurisdiction. The struggle between the SEC and the CFTC with regard to who should regulate some of the emerging financial instruments went on much too long. It seems to me as new instruments come along there may be continuing disputes with regard to those matters, and I would think it would be desirable to have an authority to resolve those questions promptly and efficiently.

Third, I would think that such an agency or official would have the authority to resolve questions with regard to equality of regulation and the continuous leveling of the playing field. A prime example of inequality in my estimation today is the fact that the money market funds are subject to all the strictures of the Investment Company Act of 1940 with regard to advertising, while banks offering competitive instruments are significantly freer in what they can say, although I noted in the paper that there is apparently some move afoot to tighten up on the advertising practices of some of the other institutions.

It seems to me, fourth, that this agency or official would have the power to allocate, not in a major fashion, but in a fringe fashion, if you would, functions among agencies. For instance, if it were determined that the administration of disclosure policy by the banking regulators and by the SEC resulted in inequalities, resulted in disadvantages to the investment market because of the incomparability of various types of investments, perhaps this official or agency would have the power to vest in the SEC all disclosure responsibilities with regard to such disclosure.

As for the question of who the agency or official should be, it seems to me there are three possible solutions, only two of which I mentioned in my statement that has been submitted to you for the record.

NEW POST IN THE ADMINISTRATION

It seems to me there could be a new post in the administration, perhaps an Under Secretary for Financial Regulation; or perhaps it could be a new independent agency with either a single administrator or a multiperson administrator; or it might be finally something along the lines of the Depository Institutions Deregulatory Commission consisting of the heads of various interested departments of the Government, who would as a commission seek to resolve these questions, as it has been done with regard to the responsibilities of that commission.

If I had been testifying before last Thursday I might have suggested that perhaps the changes that would be initiated by such agency or official would become effective only if Congress did not act within 60 days, but it would seem to me that the Supreme Court has impaired, if not destroyed, that option. Nonetheless, I think there might be other ways in which the Congress could keep a continuing watch on such an agency or official as I mentioned, if through no other means than oversight hearings by this committee.

Having discussed that, I would remark on three specific items very quickly.

First of all, I think there is a growing understanding, a growing conviction among banking people that perhaps there is sense in having the SEC vested with responsibility for all disclosures with regard to investor oriented information. I think this would be a very desirable move if it were done, and it seems to me the commission has the experience, the expertise, and the know-how to do it, and I would think many of the banking regulators would perhaps be relieved to have that responsibility vested there.

I think there is a growing trend, a growing belief, that perhaps more disclosure is necessary to protect depositors, particularly those who are not fully protected by deposit insurance. I would not suggest at this time that the SEC have that responsibility, although as experience develops it may be that the disclosures there are so similar to those pertaining to investor oriented information that it should be so centralized.

Second, I would urge that the Congress not at this time merge the SEC and the CFTC. I was on the SEC at the time when we were approached with regard to the possibility of taking on the responsibilities that ultimately were vested in the CFTC. At that time I thought the expertise of the Commission and the staff was of such a nature that it did not necessarily qualify them to take on those responsibilities. The markets are different. The participants are different. And I think they must be dealt with separately, although I see an interest in more coordination and perhaps some reallocation of the turf.

That brings me to the question of turf. It seems to me again that all financially oriented instruments, instruments where the underlying instrument, if you will, is of a financial nature, logically should be an SEC responsibility.

Finally, I would suggest that maybe this is a good time—and maybe it isn't because of the complexity of the other issues—to examine the whole question of how best to regulate the financial world. Are independent agencies the best? Are arms of the executive branch the best? Are multimember agencies better than single member agencies? Those are rather basic questions that have been discussed for many years in this country in the Hunt Commission, the Ash Commission, and the Hoover Commission. Perhaps as a part of this overall examination of financial regulations it may be timely to get into those questions as well.

With regard to many of the other issues that have been talked about, the moratorium and so on, I have neither the time nor the competence to say anything that would be of help to you. I say again, I thank you for asking me to appear and I commend you for having the hearings.

[The complete statement follows:]

STATEMENT OF A. A. SOMMER, JR.
BEFORE THE COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
OF
THE UNITED STATES SENATE

Mr. Chairman, Senators.

My name is A. A. Sommer, Jr. I am presently a partner of Morgan, Lewis & Bockius, a law firm, located here in Washington. Through virtually my entire legal career, which started in 1950 and has included service as an SEC Commissioner from 1973 to 1976, I have been closely associated with the financial services industry and have observed with keen interest the increasing turbulence and profound changes that are occurring in the industry. During my time on the Commission, we contributed in some measure to this time of change by such things as mandating the elimination of fixed commissions on exchanges, which led, among other things, to discount brokerage, and permitting the onset of exchange trading of fungible options, a development which stimulated the development of other innovative investment media.

I would first like to thank you for the opportunity to participate in this great national discussion about the future regulation of our financial institutions. Probably no domestic issue rivals this one in importance. The resolution of it may well influence the quality of life of our citizens through the rest of this century and well into the next.

All of us who in any way are associated, or have been associated, with the regulation of financial institutions are keenly aware of the stresses that daily test the adequacy, the strength, the resiliency of our present regulatory structures, and I think there is near universal agreement that changes must be made. The changes -- and by now I suspect you have heard them all -- range from modest tinkering with existing structures, agencies and their powers, through various degrees of consolidation and shifting of roles and functions, to eventual consolidation of all financial regulatory powers in a single regulator or agency. This last proposal has been espoused by my good friend and fellow former SEC Commissioner, Stephen J.Friedman, who quite correctly sees the bewildering variety of investment and financial media and instruments as simply points on a continuous spectrum, each melding at its edges with its neighbors on that spectrum, thus apparently leading him to the conclusion that it is a vain endeavor to try to find a rational series of places on the spectrum at which to cut in order to apportion and allocate responsibilities among various agencies. While such a proposal has an appealing simplicity and logic to it, I think everyone, including Mr. Friedman, would agree that such a "radical" solution is not achievable in the real world we inhabit, regardless of the merits of it, at least on the near term.

However, it does contain the seeds of another proposal which I would like to present for your consideration.

Alvin Toffler in his seminal work, Future Shock, asserts that the omnipresent phenomenon of our times is change. Unlike times past when generation after generation passed with no discernible modifications in the ways people lived, in our time the ways in which we live change almost daily. He says that this characteristic of our lives will continue as far as the eye can see or the mind imagine, that the pace of change will steadily accelerate, and that the price of survival -- physical, emotional, intellectual -- will be the ability to adapt to the changes that beset us, to move with those changes, to respond to them ever more quickly as they confront us at an ever increasing rate.

That Toffler's propositions are true is amply evidenced by these hearings: were it not for the steadily accelerating pace of change in the financial world there would be no need for them. That the pace of change in the financial world is quickening is writ large in every financial journal every day: new products, new types of acquisitions, new purveyors of financial services, new configurations of institutions rendering financial services.

As we all bear witness to the insufficiencies and in some cases inequities of the present regulatory scheme, it seems to me we should pause a moment and recognize the remarkable durability and flexibility of that scheme. For half a century now it has served the nation well. Notwithstanding what are now seen as inconsistencies and inadequacies, it has provided the framework for the greatest economic expansion in the history of the world. Within this structure we have developed the means to finance this remarkable expansion and three war efforts, the most efficient and fairest securities markets in the world, and a banking system that has withstood enormous pressures and problems and which, notwithstanding present criticisms of some foreign lending, has been indispensable to the rest of the world.

Thus, the wonder is not that this structure has begun to show its age, but rather that it has survived so well for so long.

But the unassailable fact now is that historically unprecedentedly high interest rates, the ingenuity of financial entrepreneurs and their attorneys, the needs and desires of consumers, and a host of other circumstances have combined to demand that the structure of financial regulation be critically and thoroughly re-examined. And it is being so examined, not only within these hearings, but through the Vice President's Task Group and elsewhere in the Administration. Increasingly it is plain that the financial "playing field" is, indeed, uneven, and that in one way or another some of those offering financial services enjoy advantages over others offering competitive services as the consequence of quirks in the regulatory structure. The most notorious instance perhaps is the situation of money market funds vis-a-vis money market deposit accounts. The former must operate under all the disclosure and regulatory burdens of the Investment Company Act of 1940, while at least some of the latter are subject to the reserve requirements of the Fed (but they do enjoy the benefits of federal insurance).

It is clear that, notwithstanding the current concensus that business has become unduly burdened with regulation, some minimum of regulation of financial institutions and financial practices is essential. It may be possible to strip away the whole regulatory structure of the airline industry; it would be disasterous to do the same thing in the financial industry.

If we accept this proposition that some regulation of our financial institutions -- and I would suggest that it must of necessity be fairly extensive and complex given the total dependence of our economic system upon these institutions and activities -- is essential, it ill behooves the government, either because of neglect, or inadvertence, or deliberate deed, to permit the system of regulation to be other than absolutely fair to everyone involved in providing financial services. Excessive government regulation is bad; unfair government regulation may be even worse.

Given the rapid changes we are experiencing in the financial services industry, and the near certainty that these will continue indefinitely, it is questionable whether Congress can now, in 1983, write laws that will endure and provide a fixed framework for the financial activity of the nation over the next half century, as the Congress did half a century ago. But on the other hand, Congress cannot write responsible legislation that is too ephemeral, that must be annually, or even every five years, reopened and re-examined and revamped to bring it into further congruence with the changing economic realities; the number and complexity of the issues which Congress must address simply cannot permit such a recurring effort.

Given, then, the need for some permanence; given the compelling necessity that government maintain a level playing field for all the players; given the speed with which change is occurring in the financial world and the likelihood that if anything the pace of change will accelerate, it seems to me that an essential element of any legislative endeavor by the Congress must be a mechanism that will permit the constant adjustment of whatever regulatory system it establishes to replace the one we have to assure that the playing field remains level regardless of what ingenuity and imagination may bring about; that as the economic scene changes and new investment media are developed, as new types of transactions and new modes of dealing are developed, the regulation of them is fitted rationally into the regulatory scheme with a minimum of delay and difficulty.

No matter how great the care with which Congress approaches the task of reregulating the financial services industry, no matter how far-sighted it may be, it is not an affront to the Congress to suggest that all the permutations of the next five years, let along those of the next ten or twenty, cannot possibly be foreseen. Who could have foreseen in 1973, when the SEC authorized exchange option trading, the tremendous growth of options and the onset and popularity of financial futures contracts?

All of this leads me to suggest that any Congressional restructuring of the financial regulatory mechanisms should include a means of continuously adjusting the responsibilities of the various regulatory agencies, resolving disputes over turf, avoiding conflicting interpretations of statutory language, and in general assuring that the various regulatory agencies (assuming there remain several, as I feel there will) move in concert to assure equal and fair regulation of everyone in the game.

Thus, I am led to the conclusion that there should be some government official or agency that is given a limited authority over the activities of all financial regulatory agencies -- the SEC, the CFTC, whatever banking regulators that survive the de-regulation process, including the Federal Reserve Board and the depository institution insurance agencies. This officer or agency should have the power to do several things:

1. It should have the power to definitively resolve conflicting interpretations of law. For instance, it would have the power to determine whether the interpretation of the Fed or that of the Comptroller of the Currency with respect to investment banking firms acquiring "non-banks" was more in keeping with the intent of Congress.

2. It would have the power to resolve questions of disputed jurisdiction. Again an example: it could early on

have resolved the dispute between the SEC and the CFTC concerning their respective powers and responsibilities with respect to the financial futures contracts.

3. It would have the power to resolve all questions raised with respect to equality of regulation and the levelling of the playing field. For instance, it would have the power to compel the appropriate bank regulatory agencies and the SEC to adopt uniform rules with respect to the advertising of money market instruments. It might first be required to seek an equalizing through consultation with the interested agencies, but if that failed, it would have the power to adopt rules that would become the rules of those agencies and would supercede any conflicting rules.

4. It would have the power to reallocate functions among the agencies if it determined that such was necessary to achieve efficient regulation and the achievement of fair and equal regulation among competitors. For instance, it might determine that all disclosures by publicly held companies, regardless of their industry, should be regulated by the SEC, a proposition, I might add, which is less and less disputed, even among many closely associated with the banking industry. Appropriate limits might be imposed to preclude the reassignment of any agency's "core" responsibility; for instance, the new authority could not, if Congress had chosen to leave the function of insuring bank deposits with the FDIC, transfer that function to the SEC.

Now the key question: who should the agency or official be who would have these responsibilities? I would suggest there are two directions in which the Congress might go. One would entail the creation of a new post in the Treasury Department, titled, perhaps, Undersecretary for Financial Regulation. This obviously poses problems because of the varied structures (assuming the present configurations of the agencies are not changed) of the agencies which would be subject to the authority of such official: some of the agencies are independent regulatory agencies (*e.g.*, SEC, CFTC, FHLBB) while others are parts of the executive branch (*e.g.*, the Comptroller of the Currency). While this may pose conceptual problems that might be overcome, there is also the fact that Congress has a special relationship with the independent agencies and there may be some reluctance here to having the powers of such agencies impaired or subjected to limitation by a part of the executive branch.

The other alternative would be to establish a new independent agency, either multi-person or with a single administrator, to perform these functions. If the agency were cast in commission form, it might be called something like "Commission for Financial Regulatory Coordination." Once again, the problem adverted to above would recur, but with a different thrust: again assuming the continuation of present regulatory agency configurations, you would have the somewhat anomalous situation of an independent agency, with a special relationship to Congress, having authority, at least to a limited extent, over one or more functions of the executive branch. I would hope that this would not be an insuperable obstacle. Of course, one means of eliminating the problem would be to recast all of the financial regulatory agencies in a single mold -- those that are related to the executive branch would become independent agencies, or alternatively those now independent agencies would become parts of the executive branch.

The establishment of an authority with these functions would provide the means of continuously adjusting the financial regulatory mechanism to the changing needs of the financial community and its customers, the introduction of new products, the initiation of new institutional configurations, without the necessity of a constant revisiting of this problem by the Congress.

Had these hearings been held before last Thursday, I would have suggested that any determination by the new agency or official would become effective if Congress did not within a specified period veto it. However, as we all know well, such limitations on the exercise of authority are now of uncertain constitutionality. Perhaps some means of effecting a continuing Congressional supervision of the proposed process may be developed within the framework of the Supreme Court decision. At a minimum, of course, this Committee could and presumably would maintain an oversight role with respect to the agency and the process.

There are, of course, hosts of other problems you are confronting as you seek to conform the financial regulatory mechanisms to the needs of today and the years to come. Limitations of time and competence preclude my commenting on most of them. I would, however, like to comment briefly on three matters.

First, as I suggested earlier, there is a growing concensus that the present statutorily mandated practice of the banking regulators administering a system of disclosure by banks and thrift institutions to their shareholder, with the SEC administering it with respect to virtually everyone else, is outmoded and awkward and results in uneven regulation that inhibits meaningful comparison of investment opportunities. At the recent conference at Arden House on financial regulation sponsored by the American Assembly of Columbia University, there was a surprisingly broad concensus among those attending -- people representing all kinds of financial institutions -- that investor disclosure requirements should be administered across the board by the SEC. It has the experience (fifty years of it next year), the trained staff, the expertise. It is only sensible that this responsibility should be centered there.

Increasingly the banking regulators are recognizing the importance of disclosure to depositors, especially those who are not fully protected by deposit insurance. I would not suggest that depositor-oriented disclosure be within the jurisdiction of the SEC, at least not for the present, notwithstanding that in many respects the disclosure needed by depositors is the same as that required by investors, since in a sense depositors are investors in the institution. As experience is gained with respect to expanded disclosure to depositors, it may be that the similarities between disclosure to depositors and disclosure to investors will become so apparent that the allocation of all disclosure responsibilities to the SEC would be desirable. Perhaps this judgment might be specifically delegated to the official or agency I have discussed above.

Second, I would urge the SEC and the CFTC not be merged, though I would suggest yet another redefinition of their jurisdictions to centralize in the SEC responsibility for all financial instruments that have at their foundation financial instruments that have traditionally been the domain of the SEC. Thus, I would urge that all financial futures be within the SEC bailiwick.

Finally, this may be a good time to re-examine fundamentals, such as whether the independent agency model is the best way to conduct the business of financial regulation. Is the Comptroller a better or worse, a more efficient or less efficient, regulator than, say, the FDIC or the FHLBB? If it is concluded that an independent entity is regarded as superior, is it better to have a single administrator or a multi-member agency? If the latter, is five the magic number, or could the work of the agency be done as well or better with

with three or seven members? Is there merit in the oft-repeated proposal that financial regulation should properly be conducted by the executive branch, thereby permitting better coordination of regulatory policies with broad fiscal policy?

I have no firm or fixed notions on these issues, but I do feel that in the context of your broad review of financial regulation consideration of these issues may be timely.

Again, Mr. Chairman and Committee members, I would like to express my appreciation for the opportunity to appear before you today.

The CHAIRMAN. Thank you, Mr. Sommer.

Mrs. Siebert.

STATEMENT OF MURIEL F. SIEBERT, CHAIRMAN AND PRESIDENT, SIEBERT & CO., NEW YORK, N.Y.

Ms. SIEBERT. Well, I have two things to disclose. Mr. Marston and I did reach an agreement during the intermission. We decided that you should have a study or hearings on the Federal deficit which is of great concern to both of us. So we did get together on one thing. The only thing is that since I left I'm back at my firm and I own 100 percent of Muriel Sibert & Company, Inc., members of the stock exchange, and a discount broker. So in some respects I'm competing head-on with the banks.

Thank you, Mr. Chairman. I am honored to be invited back here to testify again. It's like coming home. I hope to bring my testimony today from the perspective of a former public policymaker as superintendent of banks of New York State, and as a 20-year veteran, a vigorous competitor in the financial services industry as chairman of one of the Nation's first discount brokerage firms.

These remarks are a summary of the text I submitted to your committee.

FINANCIAL INDUSTRY HAS OUTGROWN ITS RULES

I believe, first of all, that the central problem of the financial services industry is that it has simply outgrown the rules by which it is governed. The traditional lines of demarcation among financial institutions are blurring beyond recognition today. Our regulatory process has not kept pace with technological progress or the changing demands of the marketplace. A money market fund is essentially a bank, yet it is not regulated as a bank. A $10 million or $20 million commercial bank serving one local area is subject to the same regulations as Citibank and Chase Manhattan, even though the character and functions of these banks are radically different.

Thrift institutions now resemble commercial banks, yet their regulation is very different. A bank cannot buy a mutual fund company, but a mutual fund company can buy a bank. Bank America can buy a discount brokerage firm, but a discount brokerage firm can't buy a bank. Sears, Roebuck can and does own Dean Witter Securities, All-State Insurance, Coldwell Banker real estate and one of the largest savings and loans in America, and thereby create a national financial network of awesome power and market penetration that the banks have been denied because of the law.

American Express International, owned by American Express, is a bank, incorporated in Connecticut, with full banking powers in 35 countries overseas.

The New York Superintendent of Banks regulates its limited New York State operations which is that of a foreign agency. Other pieces of the bank's operations are regulated by host governments in other countries, but no single regulatory agency, State or Federal, in this country or any other, has regulatory authority over the entire operation of this bank with nearly $8 billion in assets. This is a loophole in the law that you can drive a fleet of Brinks' armored cars through.

To restore some sense of order to this chaotic system of finance, which I really call a maze of craziness, I propose six major steps which can help bring Federal law and regulatory policy in line with modern financial practice.

MAJOR STEPS TO RESTORE ORDER

I propose, first of all, regulation by function. To the extent that any institution functions as a bank, it should be regulated as a bank. As former superintendent of banks, we regulated 16 or 17 different classes of institutions. At times the most difficult responsibility I had was to be fair and equitable to the different types of institutions because of the different regulations or laws, both State and national.

Second, to clear up some of the regulatory confusion and to do away with the artifice of nonbank banks, I propose that we change the definition of a bank from an institution that takes and makes commercial loans to one that takes deposits or makes commercial loans, and that such institutions be subject to all relevant regulation.

Third, I propose a substantial consolidation of Federal regulatory responsibility in matters of finance with much of that responsibility to be borne by the Comptroller of the Currency.

Today, there are no fewer than five Federal agencies involved in the examination and regulation of depository institutions, and frankly that's about four too many. Their regulations tend to overlap and impose needless reporting costs on the institutions and the customers and the taxpayers.

Moreover, and more importantly, the decisions of the various five Federal bank regulatory agencies are often totally different. In fact, they are downright conflicting. I use, for example, recent important decision or opinions on the creation or acquisition of banks by nonbanks. The different opinions coming out of these agencies suggest that they are just looking to protect or enhance their own turf.

There are also conflicts of interest within the various missions assigned to some of these agencies. The Federal Reserve Board, for example, cannot be expected to solicit foreign support for the dollar in its role as our central bank and still serve as an impartial bank regulator. They should not have the regulatory functions over certain foreign country's banks if they are bargaining or dealing with those countries on supporting the dollar or supporting other currencies. There can be a downright conflict.

Such conflicting missions—and they exist not only at the Federal level but at the State level as well—create what Senator Proxmire has called a competition in laxity. The regulatory agency offering the most liberal rules is the one that the banks head for even if it means going from New York to South Dakota or Delaware. The States want out-of-State business for their State. The Feds want foreign business in this country, and there's nothing wrong with either of these objectives. But when we try to meet those objectives through competition in laxity and regulation by loophole rather than with sensible regulation that is attuned to modern times, we are in danger of serving the banks all too well and serving the depositors not very well at all.

My fourth recommendation then is that we formally lift the prohibition on interstate banking, impose appropriate regulations of interstate enterprise, and let the Glass-Steagall Act go the way of the raccoon coat and the bathtub gin that were all the rage at the time of its passage. The Glass-Steagall Act was enacted the year that prohibition was repealed.

Fifth, I propose that some form of reciprocal arrangement be required of foreign interest seeking Federal charters to do banking business in the United States. Such reciprocity is required by many State banking agencies, including New York, but it is not required by the Comptroller of the Currency nor are certain reporting requirements which are standard procedure for American banks. If we are really serious about international trade in this country, we'd better recall what the word "trade" really means. When it comes to finance, the United States has a lot to trade or a lot to squander.

Finally, let me say a word about insurance. The American insurance industry with assets of almost $1 trillion is intimately and thoroughly involved in American finance. As Andrew Tobias has said, "Our insurance companies are the invisible bankers." Yet the insurance industry alone, among major American business enterprises, remains totally untouched by Federal regulation and specifically exempt from Federal antitrust statutes.

While we agonize over which financial institutions can buy other financial institutions or offer their services, the insurance industry proceeds to buy major financial service organizations without debate. I cite as an example the acquisition of Bache & Co. by Prudential Insurance.

My sixth and final recommendation is that the insurance industry be made subject to any and all Federal regulations which govern any other financial service institution in the performance of similar or like functions.

My predecessors on this panel have made excellent suggestions and the task force on financial services headed by Vice President Bush is also doing some important work. I would like to add one thing. I started and I own my own Wall Street firm which became a discount firm May 1st, 1975, the first day that member firms were allowed to negotiate commission. The banks are now competing with us head-on. While I welcome the legitimacy the banks have given to discount brokers—and that happens to be true because when the banks got into the business, discount brokers became an acceptable form of the industry. Two of the largest discount brokers, Schwab and Rose & Co. have been bought by banks, Bank of America and Chase Bank. Some banks like Citicorp and Chemical are entering the business de novo. Some of the rates, in my opinion, are so low that they would be and are clearly loss leaders. I must question the equity of my tax dollars supporting the LDC loans of the banks and hence the banks themselves who are really undercutting our business.

That's a little beside the point, but the banks are getting into this industry. They are going into other industries and I would probably say that the people in some of those industries feel the same way that I do.

I believe the time for study must finally yield to a time for action. A great many regulatory bodies and a great many more financial institutions are waiting for Congress to move banking law out of the dark ages and into modern times. I believe the time for constructive action is close upon us and I really hope that this committee agrees.

Thank you.

[The complete statement follows:]

TESTIMONY OF
MURIEL SIEBERT
TO THE
SENATE BANKING COMMITTEE
JUNE 29, 1983

MR. CHAIRMAN, I AM HONORED BY YOUR INVITATION TO APPEAR AGAIN BEFORE THIS DISTINGUISHED COMMITTEE, AS I WAS PRIVILEGED TO DO SO OFTEN DURING MY TENURE AS SUPERINTENDENT OF BANKS FOR THE STATE OF NEW YORK.

HAVING RETURNED TO THE PRIVATE SECTOR, AS CHAIRMAN OF THE DISCOUNT BROKERAGE FIRM I FOUNDED SOME YEARS AGO, I HOPE TO BRING TO MY TESTIMONY TODAY THE PERSPECTIVES OF BOTH A FORMER PUBLIC POLICY MAKER AND A VIGOROUS COMPETITOR IN THE FAST-CHANGING FINANCIAL SERVICES INDUSTRY.

I WISH, FIRST OF ALL, TO COMMEND THIS COMMITTEE FOR ITS COMPREHENSIVE INQUIRY INTO THE STRUCTURE OF THE FINANCIAL SERVICES INDUSTRY AND THE FAR-REACHING IMPLICATIONS OF ITS RAPID EVOLUTION.

YOU HAVE ALREADY HEARD THE TESTIMONY OF MANY OF THE BEST EXPERTS ON THIS COMPLEX ISSUE, AND IT IS MY HOPE THAT THIS EXTENSIVE INVESTIGATION IS ONLY THE PRELUDE TO THE COMPREHENSIVE REGULATORY REFORM WHICH THE FINANCIAL SERVICES INDUSTRY SO URGENTLY NEEDS.

LAST YEAR, THE CONGRESS ENACTED A SERIES OF SWEEPING REGULATORY REFORMS FOR DEPOSITORY INSTITUTIONS. THESE REFORMS INCLUDED EVERYTHING FROM AN EXPANSION OF INSTITUTIONAL RESCUE POWERS TO THE SIMPLIFICATION OF RULES FOR ESTABLISHING A CREDIT UNION.

But as this Committee well knows, Mr. Chairman, the work of reform in the financial services industry is far from complete.

I intend to concentrate today on six major steps which, in my opinion, ought to be taken to bring Federal law and regulatory policy in line with modern financial practice.

My first recommendation is a substantial consolidation of Federal regulatory responsibility in matters of finance, with much of that responsibility to be borne by the Controller of the Currency.

As the chairman of the State Liaison Committee to the Federal Examination Council during my service as New York's Superintendent of Banks, I found myself dealing with no less than five federal regulatory bodies: The Federal Reserve Board, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, the National Credit Union Administration, and the Controller of the Currency.

Five regulatory bodies is about four too many, not only because their regulations can tend to overlap and impose needless reporting costs on financial institutions and their customers, but also because there are conflicts of interest within the various missions assigned to these agencies.

THE FEDERAL RESERVE, FOR EXAMPLE, NOT ONLY HAS TO WORRY ABOUT MANAGING THE MONEY SUPPLY, FIGHTING INFLATION, SUPPORTING THE DOLLAR INTERNATIONALLY AND SERVING AS OUR CENTRAL BANK; IT ALSO HAS TO WORRY ABOUT BEING A WATCHDOG FOR SEVERAL THOUSAND OTHER FINANCIAL INSTITUTIONS.

WITH SUCH A MULTITUDE OF FUNCTIONS CAREENING AROUND ONE AGENCY, THE PROSPECT OF COLLISION SIMPLY CANNOT BE AVOIDED.

SEVERAL YEARS AGO, FOR EXAMPLE, THE FED WAS ATTEMPTING TO WIN SUPPORT FOR THE DOLLAR FROM THE GERMANS AND OTHER COUNTRIES WHOSE CURRENCIES WERE ESPECIALLY STRONG AT THE TIME.

ONE HAS TO WONDER WHETHER THE FED COULD BE AN ABSOLUTELY NEUTRAL BANK REGULATOR IF A GERMAN BANK SOUGHT TO ACQUIRE A MAJOR AMERICAN BANK IN THE COURSE OF SUCH SENSITIVE AND IMPORTANT NEGOTIATIONS.

THE FED IS ALSO THE LENDER OF LAST RESORT FOR LOANS TO LESS DEVELOPED COUNTRIES, AND IT HAS THE ONLY VOTE ON THE FOREIGN LOAN EXPOSURE COMMITTEE.

STATE BANKING OFFICIALS -- INCLUDING THE SUPERINTENDENT OF BANKS FOR NEW YORK STATE, WHO SUPERVISES MANY OF THE LARGEST BANKS IN THE WORLD, WITH HUGE OVERSEAS EXPOSURES-- HAVE NO VOTE BUT ONLY "OBSERVER" STATUS ON THIS COMMITTEE.

THERE IS, THUS, NO SYSTEM OF CHECKS AND BALANCES AGAINST THE OVER-EXTENSION OF CREDIT TO FOREIGN INTERESTS, AND EXPERIENCE HAS ALREADY PROVEN THE ENORMOUS FINANCIAL RISKS ENTAILED IN SUCH CREDIT OVER-RUNS.

BUT THE FED SHOULD NOT BE SINGLED OUT AS THE ONLY POTENTIAL SUBJECT FOR REFORM.

THE FDIC AND THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION COULD HAVE THEIR INSURANCE RESPONSIBILITIES CONSOLIDATED WITH NO HARM TO ANYONE.

IN ADDITION, THEIR REGULATORY ACTIVITIES COULD BE PERFORMED AS WELL OR BETTER BY THE CONTROLLER OF THE CURRENCY, OR BY THE STATES.

AS IT STANDS NOW, WE HAVE TWO INSURANCE AGNECIES PERFORMING THE SAME FUNCTION BUT WITH DIFFERENT POLICIES. IF A SAVINGS BANK HAS A STATE CHARTER, IT IS INSURED BY THE FDIC. IF THE SAME KIND OF INSTITUTION -- ONLY WITH A DIFFERENT NAME -- HAS A FEDERAL CHARTER, IT IS INSURED BY THE FSLIC.

THE FDIC HAS DIFFERENT REGULATORY AUTHORITY OVER STATE-CHARTERED COMMERCIAL BANKS AND FEDERALLY-CHARTERED COMMERCIAL BANKS, WITH MUCH MORE CONTROL OVER STATE BANKS THAN FEDERAL.

WE HAVE, IN EFFECT, DIFFERENT STROKES FOR SIMILAR FOLKS.

IT MAY WELL BE THAT ALL FEDERAL BANKING REGULATORY ACTIVITIES COULD BE CONSOLIDATED INTO THE OFFICE OF THE CON-ROLLER WITH VERY POSITIVE RESULTS FOR THE BANKING INDUSTRY AND THE CONSUMER ALIKE.

The only danger in such a consolidation is the concentration of too much power in one agency. But if the State regulatory bodies remain strong, the necessary safeguards can be preserved.

If, for example, a major financial institution -- whether a bank, a Merrill Lynch, or a Sears Roebuck -- wants to buy the largest bank in Idaho (a bank that may not be as big as New York City bank's branch office but is the financial anchor of a whole State), that State's banking regulators should be able to say "yea" or "nay" to that kind of significant acquisition.

Today, the checks and balances in regulatory power are often askew because many States require more of banks -- especially foreign banks -- than the Federal government does.

To get a bank charter in New York State, for example, foreign interests must pledge some kind of reciprocal arrangement for a New York bank in the applicant country. The Controller of the Currency imposes no such requirement of reciprocity for granting a Federal charter, and where none is required, none is offered.

During my service as Superintendent, we were negotiating with the Bank of China, which wanted to come to New York. We asked the Chinese to take in one New York bank -- either State or Federally chartered -- in return.

The Chinese abruptly decided to seek a Federal charter, instead, for which no reciprocal agreement is required. A Federal charter was routinely granted, and the Bank of China came to the richest banking market in the world with full banking powers, while New York banks have no such powers in China.

I believe that foreign interests wishing to establish a local point of exchange for the world's best currency and the world's largest economy in one of the world's most stable political environments should accept some minimal standard of reciprocity.

Americans used to be known throughout the world as good "Yankee traders" who could drive a hard but fair bargain with anyone on earth. Our commercial motto was "never give away what you can sell."

But now we seem to think that "trade," in the most fundamental sense of that word, is beneath our dignity. We can talk about free trade versus fair trade all day long, but until we recall what "trade" really is, this country will be at a serious competitive disadvantage in the world.

MY SECOND RECOMMENDATION TODAY, THEN, IS THAT SOME FORM OF RECIPROCAL ARRANGEMENT BE REQUIRED OF FOREIGN INTERESTS SEEKING FEDERAL CHARTERS TO DO BANKING BUSINESS IN THE UNITED STATES.

WHAT WE HAVE NOW IS WHAT SENATOR PROXMIRE HAS APPROPRIATELY CALLED A "COMPETITION IN LAXITY." THE REGULATORY AGENCY OFFERING THE MOST LIBERAL RULES IS THE ONE BANKS HEAD FOR -- AND NOT ONLY FOREIGN BANKS.

IT IS CERTAIN -- AND IT IS ENTIRELY PROPER -- THAT AN AGGRESSIVE BANKING EXECUTIVE WILL SEEK AND FIND THE WEAKEST LINK IN THE REGULATORY CHAIN TO ACCOMPLISH THE BANK'S BUSINESS OBJECTIVES.

BUT THE DISTORTIONS AND CONVOLUTIONS REQUIRED TO MOVE THROUGH THESE LOOPHOLES IN THE LAW TAKE A HEAVY AND EXPENSIVE TOLL ON THE BANKS, THE REGULATORS AND ULTIMATELY THE CONSUMER.

THE CENTRAL PROBLEM IS THAT THE FINANCIAL SERVICES INDUSTRY HAS SIMPLY OUTGROWN THE RULES BY WHICH IT IS GOVERNED.

THE TRADITIONAL LINES OF DEMARCATION AMONG FINANCIAL INSTITUTIONS ARE BLURRING BEYOND RECOGNITION TODAY. OUR REGULATORY PROCESS HAS NOT KEPT PACE WITH TECHNOLIGICAL PROGRESS OR THE CHANGING DEMANDS OF THE MARKETPLACE.

WHAT MAKES A BANK A BANK, FOR EXAMPLE, IS VIRTUALLY ANYONE'S GUESS TODAY.

A MONEY MARKET FUND IS ESSENTIALLY A BANK, YET IT IS NOT REGULATED AS A BANK.

I HAVE A CASH MANAGEMENT ACCOUNT THAT STRONGLY RESEMBLES A BANK. I CAN DO ALL OF MY PERSONAL FINANCIAL TRANSACTIONS THROUGH THAT CMA. IF I BORROW MONEY TO PAY TAXES, I WRITE A CHECK ON THE CMA. IN EFFECT, I CREATE A LOAN. AND I CAN DEPOSIT MONEY INTO THAT ACCOUNT DIRECTLY.

YET BECAUSE OF THE LAW'S TECHNICALITIES, THAT CMA IS NOT CONSIDERED A BANK AND IS NOT REGULATED AS A BANK.

MONEY MARKET FUNDS ARE REGULATED BY THE SECURITIES AND EXCHANGE COMMISSION, BUT MOST ARE NOT INSURED, AS BANK DEPOSITS MUST BE.

IN ADDITION, BANKS -- UNLIKE MONEY MARKET FUNDS -- ARE EXAMINED EVERY YEAR BY STATE AND FEDERAL AUTHORITIES AND ARE GOVERNED BY A WHOLLY DIFFERENT SET OF REGULATIONS.

A $10 MILLION OR $20 MILLION COMMERCIAL BANK SERVING ONE LOCAL AREA IS SUBJECT TO THE SAME REGULATIONS AS CITIBANK AND CHASE MANHATTAN, EVEN THOUGH THE CHARACTER AND FUNCTIONS OF THESE BANKS ARE RADICALLY DIFFERENT.

THRIFT INSTITUTIONS NOW RESEMBLE COMMERCIAL BANKS, YET THEIR REGULATION IS VERY DIFFERENT.

A BANK CAN'T BUY A MUTUAL FUND COMPANY, BUT A MUTUAL FUND CAN BUY A BANK. BANKAMERICA CAN BUY A DISCOUNT BROKERAGE FIRM, BUT A BROKERAGE FIRM CAN'T BUY A BANK.

SEARS ROEBUCK CAN OWN DEAN WITTER SECURITIES, ALLSTATE INSURANCE, COLDWELL BANKER REAL ESTATE AND ONE OF THE LARGEST SAVINGS AND LOAN ASSOCIATIONS IN AMERICA -- AND THEREBY CREATE A NATIONAL FINANCIAL NETWORK OF AWESOME POWER AND MARKET PENETRATION THAT BANKS ARE DENIED BY LAW.

AMERICAN EXPRESS INTERNATIONAL IS A BANK, INCORPORATED IN CONNECTICUT, WITH FULL BANKING POWERS IN 35 COUNTRIES OVERSEAS. ITS OPERATIONS IN THE UNITED STATES ARE TECHNICALLY THOSE OF A FOREIGN AGENCY, LOCATED IN NEW YORK STATE.

THE NEW YORK SUPERINTENDENT OF BANKS REGULATES THESE LIMITED NEW YORK STATE OPERATIONS. OTHER PIECES OF THE BANK'S OPERATIONS ARE REGULATED BY HOST GOVERNMENTS IN OTHER COUNTRIES. BUT NO AUTHORITY REGULATES THE ENTITY AS A WHOLE.

THE FACT THAT NO FEDERAL BANKING AUTHORITY IN THE UNITED STATES IS RESPONSIBLE FOR REGULATING AMERICAN EXPRESS INTERNATIONAL AS A WHOLE WAS ALMOST ENOUGH FOR THE BANK OF ENGLAND TO DENY ITS ENTRY INTO THE BRITISH BANKING SYSTEM.

AS SUPERINTENDENT OF BANKS, I OFFERED TO EXTEND MY EXAMINATION FUNCTION FOR AEI'S NEW YORK OPERATIONS TO INCLUDE ITS GLOBAL OPERATIONS, AND THE BANK OF ENGLAND AGREED TO ACCEPT THESE EXAMINATION PAPERS.

BUT EXAMINATION IS NOT THE SAME AS REGULATION, NOT BY ANY MEANS. AND THE FACT THAT NO SINGLE AGENCY IN THIS COUNTRY OR ANY OTHER COUNTRY HAS REGULATORY AUTHORITY OVER THE ENTIRE OPERATIONS OF A BANK LIKE AMERICAN EXPRESS INTERNATIONAL -- WITH NEARLY $8 BILLION IN ASSETS -- IS A LOOPHOLE YOU CAN DRIVE A FLEET OF BRINKS' ARMORED CARS THROUGH.

AND THE LIST GOES ON AND ON. OUR FINANCIAL SYSTEM IS GETTING SO FRAGMENTED, IT IS ALMOST BEYOND REGULATION, AND ARCHAIC LAWS LIKE GLASS-STEAGELL ARE HONORED ONLY IN THE BREACH.

TO RESTORE SOME SENSE OF ORDER TO THIS CHAOTIC SYSTEM, MY THIRD RECOMMENDATION IS THAT TO THE EXTENT ANY INSTITUTION FUNCTIONS AS A BANK, IT SHOULD BE REGULATED AS A BANK.

I RECOMMEND, FOURTHLY, THAT WE CHANGE THE DEFINITION OF A BANK FROM AN INSTITUTION THAT "TAKES DEPOSITS AND MAKES COMMERCIAL LOANS" TO ONE THAT "TAKES DEPOSITS OR MAKES COMMERCIAL LOANS."

AND FIFTH, I RECOMMEND THAT WE LIFT THE PROHIBITION ON INTERSTATE BANKING AND LET GLASS-STEAGELL GO THE WAY OF THE RACCOON COAT AND BATHTUB GIN THAT WERE ALL THE RAGE AT THE TIME OF ITS PASSAGE.

THE ARTIFICE OF A "NON-BANK BANK" HAS NO PLACE IN A WELL-ORDERED FINANCIAL SYSTEM, AND STATE BOUNDARIES HAVE COME TO MEAN AS MUCH IN FINANCIAL TERMS AS A WAVE IN THE OCEAN.

FINALLY, LET ME SAY A WORD ABOUT INSURANCE. SHERLOCK HOLMES SOLVED ONE OF HIS MOST CELEBRATED CASES BY RECALLING THE DOG THAT DIDN'T BARK. THE AMERICAN INSURANCE INDUSTRY IS ONE OF THE QUIETEST INDUSTRIES IN THE WORLD -- BUT IT IS ALSO ONE OF THE MOST PERVASIVE AND POWERFUL.

DISCUSSING FINANCIAL SERVICES WITHOUT DISCUSSING INSURANCE IS LIKE WALKING THROUGH A FOREST AND IGNORING THE TREES.

THE AMERICAN INSURANCE INDUSTRY, WITH ASSETS OF ALMOST A TRILLION DOLLARS, IS INTIMATELY AND THOROUGHLY INVOLVED IN AMERICAN FINANCE. AS ANDREW TOBIAS HAS SAID, OUR INSURANCE COMPANIES ARE THE "INVISIBLE BANKERS."

YET THE INSURANCE INDUSTRY, ALONE AMONG MAJOR AMERICAN BUSINESS ENTERPRISES, REMAINS UNTOUCHED BY FEDERAL REGULATION.

AS MR. TOBIAS HAS NOTED, THE PURCHASE OF CASH-VALUE LIFE INSURANCE MAY BE THE LARGEST INVESTMENT MANY FAMILIES EVER MAKE, BUT THE SECURITIES AND EXCHANGE COMMISSION HAS NO JURISDICTION OVER SUCH PURCHASES.

WHAT MAY BE MORE TROUBLESOME IN TODAY'S FAST-CHANGING FINANCIAL ENVIRONMENT IS THE FACT THAT THE INSURANCE INDUSTRY IS SPECIFICALLY EXCLUDED FROM FEDERAL ANTI-TRUST STATUTES.

WHILE WE AGONIZE OVER WHICH FINANCIAL INSTITUTIONS CAN BUY OTHER FINANCIAL INSTITUTIONS, OR OFFER WHICH VARIETY OF SERVICES, THE INSURANCE INDUSTRY PROCEEDS TO BUY MAJOR BROKERAGE FIRMS AND OTHER FINANCIAL SERVICE ORGANIZATIONS WITHOUT DEBATE. I CITE AS AN EXAMPLE THE ACQUISITION OF BACHE SECURITIES BY PRUDENTIAL INSURANCE.

I DO NOT SAY THAT SUCH ACQUISITIONS AND OTHER ACTIVITIES BY INSURANCE COMPANIES ARE INHERENTLY WRONG. I DO SAY THAT WHILE THIS COMMITTEE IS LOOKING AT THE STRUCTURE OF THE FINANCIAL SERVICES INDUSTRY, IT CANNOT IGNORE INSURANCE.

MY SIXTH AND FINAL RECOMMENDATION, THEN, IS THAT THE INSURANCE INDUSTRY BE MADE SUBJECT TO ANY AND ALL FEDERAL REGULATIONS WHICH GOVERN ANY OTHER FINANCIAL SERVICES INSTITUTION IN THE PERFORMANCE OF SIMILAR FUNCTIONS.

WE NEED, ABOVE ALL, TO MODERNIZE OUR WHOLE LEGAL AND REGULATORY APPROACH TO THE FINANCIAL INDUSTRY, RECOGNIZING THE NEW REALITIES OF TECHNOLOGY, OF DIVERSIFIED SERVICES, OF BLURRED DISTINCTIONS, AND RECOGNIZING TOO THE IMPORTANCE OF FAIR BUT VIGOROUS COMPETITION IN THE INTERNATIONAL FINANCIAL MARKETPLACE.

MY PREDECESSORS AT THIS PANEL HAVE MADE MANY EXCELLENT SUGGESTIONS IN ADDITION TO THE RECOMMENDATIONS I HAVE MADE TODAY. THE TASK FORCE ON FINANCIAL SERVICES REGULATION, HEADED BY VICE PRESIDENT BUSH, IS CONSIDERING A FULL RANGE OF MODERNIZING OPTIONS, AND I APPLAUD THAT COMPREHENSIVE APPROACH AS I APPLAUD THIS COMMITTEE'S.

BUT THERE IS A TIME FOR STUDY AND A TIME FOR ACTION. A GREAT MANY REGULATORY BODIES AND A GREAT MANY MORE FINANCIAL SERVICE INSTITUTIONS ARE WAITING FOR CONGRESS TO MOVE BANKING LAW OUT OF THE DARK AGES AND INTO MODERN TIMES.

I BELIEVE THE TIME FOR CONSTRUCTIVE ACTION IS CLOSE UPON US, AND I HOPE THIS COMMITTEE AGREES.

# # #

The CHAIRMAN. Thank you very much.

Mrs. Siebert just said that McFadden and Glass-Steagall should go the way of the raccoon coat and bathtub gin, and all those things occurred in the same year, and I hate to admit it, but I'm the same age as Glass-Steagall as well. So I don't know whether I should go the way of the raccoon coat and bathtub gin or not.

Mr. Smith, what do you think of Glass-Steagall and McFadden?

GLOBAL JOB OF DEREGULATION

Mr. SMITH. My testimony, while general, Mr. Chairman, suggests that I think you need to do a near global job of deregulation in terms both of products under Glass-Steagall and geography, and at least McFadden is one part of it.

I don't suggest that that has to happen in one stroke of the pen except that the transitional arrangements be laid out so that we can begin to have some rational business plans worked out as to safety, for example. Probably that should occur on a regional basis and it probably should occur in a manner in which dominant firms in regions are treated somewhat differently than other firms. But you have a period of time in which various institutions can build up to a certain scale that will make them more competitive in a less regulated world.

Yes, I think we need to get at the task across the board and I think that will produce more rational, more moderate behavior on the part of the deregulated institutions.

The CHAIRMAN. What about the suggestion on the McFadden Act that if it is changed and interstate branching is allowed that we set a 5-percent limitation on size?

Mr. SMITH. I don't think very highly of those sorts of absolutes frankly, Mr. Chairman. There is plenty of room, as you look at the whole sphere of the financial services industry—there is plenty of room for the growth in concentration without reaching dangerous levels of concentration, and the trouble with those 5 percent kinds of rules is that they tend to look at institutions in the aggregate and the competition does not occur in the aggregate. The competition occurs in the submarkets of product and submarkets of geography and you don't learn very much by looking at an aggregate position in the industry. So I don't think they achieve a great deal.

Frankly, I'm perfectly happy. We've had 19 years or more of considerable success with the antitrust laws of this country and I'm perfectly happy to let those antitrust laws apply and work. They've fashioned some pretty good law for the total economy.

The CHAIRMAN. Mr. Marston, what are your specific recommendations on the Glass-Steagall and McFadden Acts?

Mr. MARSTON. I think we may be laboring under a misapprehension or at least a premise that I'm not sure is accurate, and that is that financial intermediaries such as Sears and Prudential-Bache and these others are going to take over the world. I don't think that's clear.

I'm sure that it's true here in Washington, but the next time you go downtown take a look around Woodies. I'm sure it's true in Boston. We have two big department stores at a street corner of Summer and Washington Street. There's Filene's with their famous basement, and Jordan-Marsh. They sell a wide range of products. They are, in a sense, profit intermediaries. They include shoes. You can go in there and buy a pair of shoes.

Within one block, just on Winter Street, there are five boutique type of shoestores that sell and specialize in shoes. I don't know who does the better job, but if you went in a one-block radius all around them there must be 10 or 15 people specializing in all sorts of shoes.

I'm just using that as an analogy and suggesting that I agree with Rex Duwe who was president of the American Bankers Association several years ago who said, "if Citibank wants to come in our town with their ATM"—he's from some town in Kansas someplace in a small bank—he said, "I'll show you the most expensive loss leader you've ever seen."

So I'm not sure that in fact this is going to happen, No. 1.

No. 2, to pick up on something that Jim Smith said here, and he said, "I think you have to be careful that restricting people from branching—some types of institutions from branching, for example, or going into different product lines—you've got to be careful that it doesn't weaken the institutions." It seems to me that the State of Illinois with their unitary banking restrictions and I read in the paper that perhaps some of the problems in Tennessee came about because there were restrictions on branching. And so you have a group of very small institutions in a time when either—well, there is a certain benefit to a certain size. What that is I don't know, say $500 million or $250 million or more. I'm not talking about necessarily huge giants.

So applying that to McFadden and Glass-Steagall, I think that it's happening in the marketplace. I think you are getting this expansion. I think it should be allowed to happen in an orderly way, but maybe in a chaotic way as well. So I'm saying it's happening in the marketplace and therefore I'm for it.

FIVE-PERCENT LIMITATION

The CHAIRMAN. Mr. Coldwell, you suggest taking down some of the barriers but in your testimony recommended a 5-percent limitation. Do you really foresee, in light of how the example was used on Monday—we had seven chief executive officers from many of the companies we're talking about—Sears, American Express, Prudential-Bache, and on down the line, each of the seven testified they exist in competitive markets. Bank America, Mr. Armacost, testified he was in a very competitive environment in California. Bank America is obviously huge and yet there were more new banks last year in California, or financial institutions, than any year in history, more independents. And Bank America, despite their size, was not able to crowd them out in California.

Mr. Wriston of Citicorp, when I asked him how successful he had been in upstate New York in competition with the small independents, his answer was, "They cut off my head and handed it back to me." And it was an expensive lesson and he was not successful up there. Maybe New York and California are not indicative of the whole country, but it seems to me there is all kinds of evidence that even with the giants, that competition has continued and, as a matter of fact, the competition couldn't be more intense in those two States without setting artificial limitations.

Would you respond further on your recommendation of a 5-percent limitation?

Mr. **Coldwell**. Well, let me make a couple of other comments first, Mr. Chairman.

On the Glass-Steagall question, as I said in parts of my testimony, I'm perfectly willing to allow further erosion into that, but within very limited areas. I think we have seen, and are seeing right now, the dangers in granting authority to move the credit-granting institutions into mergers with credit-using institutions. It's been a historical problem to all of the regulators and it's going on right now in a number of other countries. In Germany, the banks just the other day were taking a look at the question of holding equity within some of the nonfinancial institutions. We've seen nationalization in some countries caused in large part by the nonfinancial ownership.

So I'm willing to bend some in the direction of the enlargement of the industry, but I certainly would hope that we don't go too far in this area.

The **Chairman**. Being specific, are you talking about revenue bonds and money market mutual funds?

Mr. **Coldwell**. I have no problems with either one of those, Mr. Chairman. I would have problems if you would allow this industry, as Mr. Smith seems to imply, to be able to go on to buying chemical companies and oil companies or make major investments in such items.

As far as the McFadden Act is concerned, my testimony indicates that I'm willing to have Congress look at the limitation of that restriction. I think it's an artificial one and we do run into problems in such artificial restrictions.

Then I have to put my opposite hat on with regard to this 5-percent question. I am concerned about the problem of concentration which this industry may go into. I suspect that whatever may come out are two different industries, one composed of a dozen or two dozen very, very large financial institutions, and then a whole wide range of small competitors who are cutting their heads off and handing them back to them. I suspect we will end up with that kind of a structure in this country and we are doing it right now in the sense of the large customer versus the small customer.

The 5-percent limitation I suggested to you was merely a way to make sure that we did not concentrate that down too much in the very large banks.

The **Chairman**. Mr. Sommer.

Mr. **Sommer**. Senator, I do not claim to be a banking expert but I think I have some opinions with regard to the securities industry and how it relates to the banking industry.

The **Chairman**. You don't have to be an expert in anything to have opinions around the Senate. [Laughter.]

GO SLOWLY IN REPEAL OF GLASS-STEAGALL

Mr. **Sommer**. Regarding Glass-Steagall. I recently had occasion to study rather closely the history of that and the circumstances that led to its enactment. It seems to me that if the Glass-Steagall Act were repealed there is nothing that would prevent the recurrence of some of the abuses that existed when it was enacted, such as, for instance, the securities affiliate of a commercial bank undertaking an underwriting for a bank borrower where the loan was somewhat hazardous or becoming hazardous; often the securities affiliate would undertake to make a public offering improvidently and perhaps prematurely in order to bail the bank out.

Now I don't know the frequency with which that happened. It was one of the reasons given for the enactment of the Glass-Steagall Act.

It suggests to me that if the Glass-Steagall Act were repealed some sort of a system for dealing with those potential conflicts would have to be put in its place.

There's a full spectrum of activities that comprise investment banking. With regard to the underwriting of municipal revenue bonds, I think that is one end of the spectrum and less objectionable perhaps than any of the other proposals. The underwriting, organization, management, and so on of open ended mutual funds, that's next on the spectrum in my estimation. When you get to the other end of the spectrum where you have the underwriting of corporate securities, particularly equities, where you have market making with regard to securities and exchange membership and all that sort of thing, it seems to me then you are mixing functions in the economy that perhaps would be better left separate.

While I don't fully subscribe to what Mr. Corrigan of Minneapolis said about banks being special institutions, they do have some special characteristics and I think to some extent the policy judgments made by Congress should reflect a judgment with regard to that.

So I would go very slowly in repealing in full the Glass-Steagall Act. As I said, if it were done, I think there would have to be a fairly complicated set of restrictions placed upon the banks as to activities the banks could go into.

Interstate banking. I think that's so much a fait accomplis that I'm not sure that the barriers should continue in place. I have a very strong suspicion that there will be a wave of acquisitions if the McFadden Act is repealed, and after that a subsiding. I suspect I share the opinion of Mr. Marston that you will find local banks will be highly competitive and will continue to have a piece of the turf that will be very profitable and that they will continue to be very healthy, notwithstanding the growth of a half dozen or dozen or 15 or 20 major institutions. I would very much oppose any sort of restriction with regard to the size of financial institutions other than that which flows out of the antitrust laws.

LEGISLATIVE MORATORIUM OF 6 MONTHS

The CHAIRMAN. Mrs. Siebert, there's great pressure at the present time for a simple legislative moratorium of 6 months. What's your opinion of a moratorium?

Ms. SIEBERT. Well, I usually don't like moratoriums unless I know there's going to be some action after it because it just builds up demand.

If during this period we could get a policy that would be good and creative, realistic, then I would be in favor of it.

The **Chairman**. Well, I would agree with you, but do you know of any time when Congress has done anything during a moratorium except get to the end of it and extend it?

Ms. **Siebert**. That's why I couched my answer that way. I frankly would rather see the five Federal bank regulatory agencies sit in the same room and make that decision themselves because I believe that some of the decisions that are being made now are a matter of sort of turf playing so one can be a little more creative than the other, and I think that's a bad way. That's regulation by loophole and that even I object to even though some of those loopholes may be beneficial to my own personal benefit.

The **Chairman**. I wouldn't mind a moratorium at all if we would proceed with the process I've been trying to push the last 2½ years and at the end of that time we were ready to make specific legislative proposals and act upon them. I wouldn't object at all. Six months is a very short period of time. But it's usually used as a delay tactic and it's been my experience, without some pressure to act, that Congress will not. As I said on Monday and I've said many times, my bill would not have passed without the problems of the thrifts. There's no doubt about it. And all the pressure for me to give up and just go with title I and title II was intense over a period of months—for the capital infusion and the regulators bills—and if I had been willing to give into that, that's all we would have had. There would have been no changes in the structure of the industry at all, no money market deposit accounts, just simply a regulators bill and a capital infusion which has not been used very much, fortunately, because of the improvement in the economy.

But it's been my experience, not only in the financial area but throughout all of the legislation I deal with in the Congress, that that is the normal process. We tend to put things off so we don't have to make those tough decisions and hope somehow they're not as tough at the end of that period or in some way they've resolved and gone away, and they won't. The problems get worse.

So that's why I don't favor a moratorium and will not unless I can get some real guarantees that at the end of that we would make some decisions and there would be no extensions.

Any other comments on the moratorium?

ALTERNATIVE TO A LEGISLATIVE MORATORIUM

Mr. **Smith**. Mr. Chairman, it occurs to me there may be one alternative to a legislative moratorium that you can derive from the tax legislative field and that is not an uncommon occurrence—the tax writing committees approaching what they view as a problem and are not quite certain how they are going to assault that problem and announce that they are going to hold hearings on it and announce that whatever action is taken with respect to the problem will be retroactive to a particular day. It has a chilling effect on behavior and if this committee were to announce it would begin to undertake a markup of a financial deregulation bill and one of the issues that will be treated within that deregulation bill is a definition of a bank as it appears in the Bank Holding Company Act, you might very well have the same chilling effect without the concerns about the time delays.

Frankly, I spent 30 years of my life in and around this great institution and it functions best when it is being nipped at, at the heels by the real world. If you tell the real world to stop doing what it's doing, there becomes very little justification for a legislative process to really function.

The CHAIRMAN. Well, I do expect a proposal from Treasury. They have been trying to get it out the last few days, and some of their recommendations.

Are there any other comments any of you wish to make on this subject?

[No response.]

The CHAIRMAN. Mr. Smith has criticized the administration proposal which expands the types of financial activities available to banks because at least in the past it has failed to include the whole family of thrift institutions. He believes that the thrift industry is an important component of the financial services sector and should have an opportunity for entry as all other financial businesses.

If banks are given expanded powers, he believes the same opportunity should be made available to the thrift industry.

Mr. Coldwell, do you want to start?

Mr. COLDWELL. Well, if the thrift industry is going to be a bank, then I would certainly say yes, and we have moved a long way toward making them banks. I don't think they're quite there yet and I doubt whether some of their management and personnel capabilities move very far, although I was delighted to hear Mr. Marston talking about making a commercial loan out of his savings bank. The savings bank is a different animal perhaps than the savings and loan association movement over the last few months. Nevertheless, I think the S&L's are moving toward taking on broader financial responsibilities and it would seem to me that they ought to be treated that way.

The CHAIRMAN. Mr. Marston, do you want to be a bank?

Mr. MARSTON. I aspire to greater things, Mr. Chairman. [Laughter.]

Actually, we've had some very broad powers in Massachusetts for a number of years and have been able to do almost everything that commercial banks have been allowed to do, except making some of those good foreign loans that they are into. And, Phil, that was a commercial real estate loan. It was an income property loan.

Our personal reaction—the point of what I'm saying is we've had the opportunity to make business loans for a number of years and still our balance sheets have not changed much from those of traditional savings banks over the years.

Our own institution happens to be highly liquid. Our look at the market tells us that there is in fact a paucity of intelligent bankers able to make good banking decisions and we, unlike many of our competitors, have decided not to get into the commercial banking business at this time. We think there is a long payoff period and we think that there are a lot of people out there beating the bush, as it were. What we have done so far is simply to participate with two or three of the really very good commercial banks in the Boston area.

So my answer to your question is, no, at this time we do not wish to become a commercial bank. What we do need is to develop variable assets that have more or less the same interest rate sensitivities as our liabilities do.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

Gentlemen, I know that you and Senator Garn have been talking about the moratorium before I got here. That's the penalty of being on several committees all meeting at the same time.

If you knew for a fact that the Congress really could not enact legislation until early 1984, that the legislative process was necessarily ponderous, would you favor or oppose the Fed bill?

Mr. SMITH. Senator Heinz, I think I would oppose it. I suggested just as you were coming in and you're familiar with the practice having served on the Tax Writing Committee, of announcing an intention to deal with the problem and that could be announced in connection with your writing of financial reform legislation that you would treat the issue of the definition of bank and the Bank Holding Company Act. As you know, in the tax writing area they use those announcements and they have a chilling effect on behavior.

Senator HEINZ. The Fed moratorium only runs through December 31, and I'm asking you, we both understand, to answer a hypothetical question, but as you may be aware, we are not even going to be able to take minimal testimony during the month of July even on the Fed's moratorium. We don't yet have the Treasury's proposal. Senator Garn may have mentioned this earlier, but the Fed is going to be up here a total of four times in July. First, Mr. Volcker has to come up here for his reconfirmation hearing. He has to come up and give his report on Humphrey-Hawkins. He has one other appearance he has to make, and then he will get around to testifying on the moratorium. And that means that July is gone and after that August is gone and after that we will have a number of authorizations that we are going to work on the floor on. We've got three or four pieces of legislation from this committee already pending on the floor, not to mention the famous housing authorization which the chairman is determined to do something with if he possibly can—all that by September 30.

I think the odds of Congress therefore bringing up substantive legislation on which there is just at the current time no real consensus between now and December 31 is very slim. So it's not as if this is an imaginary hypothetical. I think this is a very real hypothetical.

Now were we not to enact moratorium legislation that took us through the end of the year, I think we're all aware of the danger of a moratorium being an excuse not to act, but let's assume for the moment that there is such a thing as a good faith moratorium that is designed to preserve the options of the Congress until we do act, and the fact that there would be a limited date on the moratorium would be an ample preservation of market forces being reinstituted on January 1st, 1984, plus the fact that I think anybody who studies this issue also understands that there are a number of technological forces that are also working as imperatives.

So I would like to restate my question to you, Jim. In that kind of circumstance, which I think is very likely the real circumstance, what is our justification for allowing the totally unstructured—some people have called it cat house regulation—that is taking place right now?

MISIMPRESSIONS ABOUT NONBANK BANKS

Mr. **Smith**. Well, Senator, I don't disagree with your scenario as to what is possible given the calendar. I think there are very many misimpressions about this thing called the nonbank bank.

No. 1, it is a bank. It is regulated like any other bank in every respect but one. It is not subject to the Bank Holding Company Act. It was not an accident in 1969 and 1970—I happened to have had some involvement in that legislative action. It was a specific situation that that definition was addressed to which the Congress in 1969 and 1970 concluded did not require that type of institution to be subject to the strictures of the Bank Holding Company Act.

The fact is that the decisions using that definition that have been made by the Fed itself go back into the midseventies when the Fed decided that industrial banks, for example, were not banks under the Bank Holding Company Act but were eligible activities for bank holding companies under section 4(c)(8). It would be almost impossible to distinguish between an industrial bank and what a nonbank bank does today.

The other thing is, not much has happened. Not much has happened. We've had four or five acquisitions and a lot of discussion of possible acquisitions. We are talking about a consumer bank. I think it is useful to keep the real world nipping at your heels, Senator.

The only personal experience I've had with the legislative moratorium was the one that was adopted in 1980 on interstate trust operations that lasted for 18 months and not one whit of public policy was changed in the 18 months and we let the damned thing expire.

Senator **Heinz**. Well, two thoughts. One, the Fed wants the loophole that you've just identified closed.

Mr. **Smith**. Well, the Fed is one point of view.

Senator **Heinz**. Well, that's fine, but that is their point of view. Second, I don't think we've really come to grips with the issue about what happens if Congress decides to be ultimately, in its substantive legislation, more restrictive than kind of the loophole-oriented approach. It puts us in a very difficult position of having to decide whether to take away business privileges that have been won under the present system which we don't like to do.

Mr. **Smith**. We did that in 1970.

Senator **Heinz**. We didn't do that on the International Banking Act. We grandfathered the banks that were here and gave them an unfair competitive advantage in doing so. Or we have the alternative of permitting unfair competitive advantage.

Let me ask Mr. Marston. Mr. Marston, you are a former bank board chairman and I understand that you said that if market forces are driving financial services deregulation, you're all in favor of it.

Were people making that argument in the late twenties and early thirties?

Mr. MARSTON. Gee, I'm not that old. I don't know.

Senator HEINZ. I didn't mean to imply that you were.

Mr. MARSTON. It's been a tough 4 years, I admit.

Senator HEINZ. I will simply imply that you are a scholar of history and you won't deny it. No one wants to deny that.

Mr. MARSTON. Maybe not a good one. You mean are we going back to that laissez-faire attitude? Is that what you're asking?

Senator HEINZ. Well, if the theory is deregulation is good, it implies that we should really abandon the basic concept of safety and soundness that's been built into our banking laws since the early thirties. They were put in because of the admixture of banking with so many other financial services, broadly speaking, and there is the belief, which—I wasn't present either at the time—that because of the admixture, our system became shakey and did collapse and we had bank holidays.

And what I'm trying to find out, as somebody who has had a good deal of experience in the industry, whether you have concerns that the ultimate effect of unmitigated deregulation is really to put us back in a banking system that was kind of precrash.

Mr. MARSTON. Senator, I guess there are two aspects to my answer.

One is that in my testimony, especially that starting on page 17, in which I refer to an adjustment allowance for prepayments, what I'm saying is that there are certain market forces that prevail. Those market forces are driven by consumer preferences and so we should allow the terms and conditions of our savings instruments and our lending instruments really to be very responsive to the market.

Senator HEINZ. Well, can I say something about that? My background before I got involved in this stuff up here on Capitol Hill was in marketing. In fact, one of the things I was responsible for was new products and one of the ideas we came up with for a new product was an orange juice that would give you the same zip as coffee. You know, they put caffeine in Coca-Cola, why can't you put it in orange-plus?

Mr. MARSTON. A little brandy in there or something like that.

Senator HEINZ. What should be the plus in orange-plus? And you know, all our market research—I see people—I'll tell you afterwards. The product was going to be called Zoom, and our research——

The CHAIRMAN. It should have been called Edsel.

Senator HEINZ. Edsel went zoom in reverse I think. I'm thinking of another one, too. I'll tell you about it off the record later.

In any event, the FDA, Food and Drug Administration, will not let you put caffeine in as an additive because they feel that's not good for you, in spite of the fact that consumer preference was fantastic and frankly I think the FDA was right. We don't need to be drugging people any more than they do that to themselves. There is a somewhat stretched analogy here which is that it is all very well to meet all consumer preferences until you start paying a heavy price. And in this case, what I frankly am concerned about in moving so far that the banking system literally does become drugged on doing everything and therefore gets out of control of the regulators' ability to implement safety and soundness.

And I have to tell you there are good reasons at times to limit consumer preference. It is not a good in itself. I mean, there's a tremendous consumer preference, I'm told, for cocaine, but we don't encourage it.

Mr. MARSTON. Well, I think my first reference was really on a micro basis, that we should be in a position to take different products to the market and see what the consumer response is. I think that's highly desirable within the current product lines, within real estate mortgage loans, within consumer savings instruments and the rest. In that context there should be far more deregulation than there is now. We should be allowed to offer most anything.

Going beyond that—and I sort of sense that as macro—should we be allowed to get into everything? Should there be complete deregulation of the industry? My answer to that is, no, not immediately, if ever; however, when you come down to making the decision, I would tend to favor less regulation more than one regulation.

Let me give you one example and I think it's a very real problem that the insuring agencies face today, the FDIC and the FSLIC. Roughly—and this was going back in February—roughly 93 percent of the conventional loan production by insured thrift institutions was going into portfolio. Now that could well be an unsafe and unsound practice. It's one of the things that helped cause the demise of roughly one-quarter of the institutions, but that would be the traditional thing that they have done for years and, in my opinion, it is terribly unsafe to do that.

Is it any safer to make fixed rate long-term loans for a portfolio than it is to go out and make commercial loans with which we're not terribly familiar at this time? I don't know. It's a difficult question to answer.

In general, I am saying, go for deregulation, in general, but not immediately.

Senator HEINZ. I'm out of time and I did want to ask Mr. Coldwell one or two questions. I will restrain myself in deference to my chairman because we have one more witness, but everything we're saying is so reasonable. It really is. You know, deregulation, but not too far. Don't interrupt safety and soundness.

Our problem is that we don't know how to write a bill that does that yet and we are faced frankly with the problem that if we don't write the right kind of bill it's not going to go anywhere. There are one or two trade associations that have points of view. Jim Smith has run into them every so often I suspect, given the nature of his particular responsibilities which I admire but don't envy, and we've got to achieve a consensus on what that balance is. We're not there yet.

Do any of you think we are there, having achieved that consensus? I see Mr. Coldwell shaking his head. He doesn't think we're there. Mr. Sommer, Mrs. Siebert, I don't think you do. Mr. Marston, I don't think you do. How about you, Jim? We'll give you the last shot here.

Mr. **Smith**. No, I would agree, but I think you have to take some responsibility in forcing that action.

The **Chairman**. John, I gave them the opportunity during the vote at 10 o'clock, 15 minutes, for them to all get together and come up with recommendations and draft a bill while I was gone and they failed.

Senator **Heinz**. Well, with that kind of talent down there, I don't see how they can be too hard on us, Mr. Chairman. Thank you.

The **Chairman**. Thank you very much. We appreciate your willingness to be here, and Senator Heinz is correct; it is difficult to achieve a consensus and that is why we're in the 14th hearing to get all sorts of opinions and try and start to narrow that down.

If I could just sum up the opinions of the panel—and I think I'm correct without being specific—that you all generally favor changes in our banking laws to accommodate technological changes and market forces, but you all have emphasized that the underlying principles of the bills we talked about 50 years ago, the safety and soundness are important. I haven't heard any testimony from anybody really that simply wants to throw the baby out with the bath water and have an unlimited market and banks being in all kinds of venture capital and so on, and so it is a matter of where that balance lies.

But, in general, you would agree with those principles, to respond to technological changes that have occurred over those 50 years, but the basic principles of safety and soundness have not changed over those years and it's how we achieve that. Do we let you get into variable type instruments or do we stick you with fixed rate mortgages?

Is that a correct, very general summary of what all of you have said today?

Mr. **Marston**. There are a lot of people, though, who are very close to the kinds of things you're talking about, having those multipowers, and as the debate goes on it's likely that some of those people, to the extent it's an advantage, will increase that advantage.

The **Chairman**. Just one closing note. If we gave banks total unlimited powers, total repeal of Glass-Steagall, I'd take what little money I have out of it and put it under my mattress. So I think that's one extreme. I think the extreme now is a lot of restrictions are unnecessary. The other extreme is going all the way. We'll have to work at finding that middle ground.

Thank you very much.

Next I'd like to invite to the witness table Mr. William J. Dennis, Director of Research, National Federation of Independent Business.

Mr. Dennis, we're pleased to have you before the Committee today and we appreciate your testimony.

STATEMENT OF WILLIAM J. DENNIS, DIRECTOR OF RESEARCH, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, ACCOMPANIED BY GEORGE SAUNDERS

Mr. **Dennis**. Thank you very much, Mr. Chairman. I have with me Mr. George Saunders, a member of my staff, who will hopefully answer any questions that I might not be able to answer.

You've heard all the arguments on virtually every issue that's before us and while we provide some of that in our written testimony, I will bring those up at this time.

Instead I would like to look at small business from the perspective of smaller firms as a consumer of credit.

Essentially, I will report on the results of two major studies the Federation has undertaken which has direct implications for the issues and the activities you're now undertaking.

The first point to make is that commercial banks are the lifeblood of American small business. Eighty-five percent of all loans small businesses receive come from commercial banks. Over 90 percent of the short-term loans come from banks. Curiously enough, the second largest provider of these loans are individuals.

Second, throughout this very difficult period from 1979 through virtually the present, small business has had reasonable access to credit. There really hasn't been an availability problem. There's been an incredible price problem, as you well know, but not an availability problem.

We've learned a few other things from these studies of the small business population. We have measured bank performance by size of bank and by branching status of the State in which the bank is located. We have used objective measures and subjective measures to make the evaluation. The objective measures we used were principally price and acceptance and rejection rates. The subjective measures we used were such as whether or not the individual small business owner felt his credit needs were met, how reliable his bank was in terms of providing credit and things of that nature.

The basic finding was that small banks and banks in unit States provided better service on objective and subjective measures than did large banks and banks located in statewide branching States.

Now the differences were relatively large in 1980. By 1982 they had narrowed somewhat. Still, our data give us no reason to believe or provide any evidence that statewide branching or, for purposes of the present discussion, interstate branching, provide any benefit for smaller firms. In fact, it points in the opposite direction.

The bottom line is that it is essential for the survival and the health of the American small business population that we keep strong small banks and that we keep a multitude of those strong small banks. In the long run we feel the small bank can compete very favorably with a large bank for a small business' business. However, we believe that under current conditions where there is little clarification in current law, these things are very difficult for the small bank who in turn provides credit for the wider small business population.

CLARIFICATION OF EXISTING LAW IS NECESSARY

Therefore, we believe that a clarification of existing law is necessary, and while in the ideal of all worlds for small firms they would retain McFadden as well as Glass-Steagall and do so in such a manner that we interpret to be the spirit of the law rather than the current interpretation of the law. We nonetheless recognize that this is not to be.

Therefore, we believe that clarification of existing law through new law is essential and that the transition period, whatever it be, be very clear and allow for a slow transition from the current status to whatever the future status may be.

I originally had copies of the study that we were going to bring. One of the overnight express organizations didn't deliver them this morning, so I will have to deliver them to the staff tomorrow and I apologize for that.

The CHAIRMAN. Well, we'll be happy to include it in the record without mentioning the name of the firm that guarantees overnight delivery and did not deliver.

Mr. DENNIS. Thank you.

[The complete statement and study follow:]

NFIB National Federation
of Independent Business
The Guardian of Small Business

STATEMENT OF

WILLIAM J. DENNIS
DIRECTOR OF RESEARCH

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before: Senate Banking Committee

Subject: Deregulation of the Banking Industry

Date: June 29, 1983

Mr. Chairman, on behalf of its more than 570,000 small and independent business members, NFIB appreciates this opportunity to submit our comments on the changing structure of banking and financial services. Our membership is very concerned about these developments which promise to dramatically alter the way in which capital markets function in the United States.

Small business is a consumer group which relies heavily on commercial banks for its financing needs. Several recent studies have documented the importance of banks in providing credit to small business--not the least of which were NFIB surveys of its members' experience with financial institutions conducted in April of 1980 and again in April of 1982. The results of the surveys are being

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202 554-9000

published under the title of Credit, Banks and Small Business, and the first copies are being made available to you this morning.

Considering the change, volatility and interest levels which have typified the nation's credit markets over the last few years, it is remarkable that the recent credit experience of small firms has been as positive as it has. Most operating small businesses have continued to have access to necessary credit, and while not cheap, the cost of credit has been not much more outrageous for small business than it has for others in our society. There have been major differences in bank performance, however.

On virtually every dimension examined in these NFIB studies, whether measured objectively or subjectively, small banks and banks in unit banking states performed better for small business than did larger banks and banks in statewide branching states. The study found no evidence to support the view that statewide branching provides small business consumers a "better deal" through increased competition and achievement of scale economies. In fact, the preponderance of evidence pointed in the opposite direction, although many of the large performance differentials found in 1980 were nearly eliminated by 1982.

Price and loan acceptances/rejections represented the principal objective measures examined. The 1980 study found, for example, that small banks provided short-term (1-12 months) and medium-term (13-60 months) loans to smaller firms at approximately 100 basis points lower than did large banks. Two years later differences were largely eliminated, but larger banks and those in statewide branching states certainly didn't enjoy any advantage. A similar pricing structure was observed in comparing unit and branching states. In 1980, small businesses in unit states received a comparatively good deal. While much of that advantage was lost by 1982, small firms in unit states still retained a 40 basis point advantage on short-term loans.

A second objective measure employed was the acceptance/rejection rate on small business loan applications. On balance, most operating small firms (85%) had their latest loan request accepted. However, small firms in statewide branching states experienced a lower acceptance rate and a higher rejection rate than did those in other states. By 1982, the rejection rate was twice as large in statewide branched states as in unit states.

The only measure on which banks preformed better in branched states was on actual solicitation. A greater percentage of small firms were directly solicited for their business in branched states.

The preference for small banks and those in non-branched states was even more pronounced in evaluating subjective measures. A general review of perceived credit needs being met provided small banks in unit and limited locations a slight edge. However, in evaluating personal and service dimensions, major differences appeared. Small business owners believed the two most important attributes in a bank were "Knows Me and My Business" and "Reliable Source of Credit." Both were evaluated as more important than "Cheapest Money Available"--an obvious price dimension. And both saw small business owners in statewide branching states evaluate their banks worse on those criteria than did owners in other states.

The personal and service dimensions on which banks in branch states generally competed on a favorable footing were those characteristics of least importance to small business owners. "Convenient Location" and "Provides a Wide Range of Services" provided the two best examples.

A Survey of Commercial Bank Lending to Small Business conducted by the Interagency Task Force on Small Business Finance provided data from the suppliers of credit and made many of the same points. It indicated that about 75 percent of loans to small firms are made by small- and medium-sized banks. Loans to small firms made up 95 percent of the loan portfolio at small banks and 77 percent at medium-sized banks. This contrasted sharply with large banks, where only 13 percent of the loan portfolio is held by small business. The same study indicated that small banks charged lower interest rates on small business loans than medium- and large-sized banks in three different categories. And smaller banks were more willing than large banks to make loans to small firms without personal endorsements or guarantees.

The Interagency Task Force study also produced results similar to the NFIB study with regard to interest rates: they tended to be lower the more restricted the branching and holding company activity is. And again, where statewide branching exists, less than half of bank loan portfolios consisted of small business loans as compared to close to two-thirds where limited branching or unit banking exists. This kind of data contradicts the claims made by some that liberalized branching automatically increases competition, thereby increasing the availability of credit, reducing the cost of credit, and improving bank service to small borrowers. In fact, it implies just the opposite.

Given the better performance of smaller, local banks, it should be no surprise that NFIB members have voted heavily against interstate banking in policy deliberations. Small businessmen and women are very concerned that as geographic restrictions are eliminated, the small banks on which they rely will be taken over by large banking conglomerates, whose focus will be on deposit taking and consumer lending rather than making commercial loans. They are afraid that their money will be channeled toward large corporations in money centers and toward international investments. Small businesses are also concerned about large banks getting into other fields, such as insurance and securities brokerage, simultaneously draining capital available for commercial credit and becoming competitors of existing small firms in such fields. As a result, NFIB members have voted strongly against allowing banks to cross over the existing line between banking and commerce.

These votes should be viewed in context. NFIB's membership has consistently supported pro-competitive, free market-oriented legislation. What we are saying in this instance is that it is not at all clear from the data available that deregulation of the geographic markets and product lines of commercial banks will ultimately increase competition. It is our belief that, left to take its own course, interstate banking and the entry of banks into ever-increasing lines of commerce will lead to undue concentration of economic resources in large money center and regional banks and a concurrent drying up of available capital in smaller towns and communities.

It is true that in some small towns and rural areas, there may be only one bank which has an effective monopoly due to branching restrictions. Such a place may not need or be able to support another bank. But in this case, the financial health of the monopolist is inextricably tied to the health of the local economy.

It is in the best interest of the bank to serve the community as well as it can. This probably would not be true if the bank were acquired by a large multinational company headquartered in one of the money centers. There would be some incentive to reap monopoly profits to the greatest extent possible and simply close operations when profits dried up.

There is serious question among leading experts about the ability of this nation's anti-trust laws, the Bank Merger Act, and the Bank Holding Company Act to prevent wholesale mergers and acquisitions. FDIC Chairman Isaac has raised the argument that current laws not only are inadequate, but may actually favor the expansion efforts of large banks. Arnold Heggestad, William H. Dial Professor of Banking at the University of Florida and a visiting Senior economist at the Fed, favors interstate banking, but argues that antitrust laws "would have no effect on limiting interstate expansion. Under current interpretations, the largest U.S. banks would be able to acquire banks that were dominant in their markets across the country with virtually no antitrust limitations."

For example, Heggestad notes that if Bank of America acquired the largest banks in Texas and Florida, its share of U.S. domestic deposits would increase from 4.14 percent to 5.41 percent, hardly grounds for challenge under existing antitrust standards. We have already seen Bank of America agree to merge with Seafirst, the State of Washington's largest bank, and bank mergers have increased rapidly in the past two years, not exclusively among problem banks. Stephen Rhoades, a senior Fed economist, has stated that, "If we go to interstate banking, we'll have a merger movement that will knock your socks off." And Edward Guay, Chief Economist for Cigna Corporation, predicts that only 100 banking concerns will remain by the turn of the century. This issue simply cannot be dismissed as easily as it has been by some.

We are fully aware of the studies which indicate that economies of scale in banking are dissipated somewhere above $50 million in assets. This may mean that large banks will not be able to exploit cost advantages in competing with small banks. However, we disagree strenuously with Assistant Attorney General William Baxter's contention before this committee that large banks would have no advantage in competing with small banks. Very large, diversified firms have other sources of revenue available, often referred to as a "deep pocket." This gives them the ability to enter a market by cutting prices below cost and operating at a loss long enough to drive small competitors out of business, at which time prices may be raised to a level above that found under competitive circumstances. In the long term, local credit customers will not benefit from this type of "competition."

Moreover, there is some evidence that so-called economies of scope (defined as when the combined cost of producing two or more products in the same operation is lower than the combined cost of producing the same product separately) accrue to large banks as they increase the number of products offered. Adding to a bank's product line appears to reduce the cost of existing products, a situation that benefits large banks, whereas smaller institutions show no economies of scale in traditional products.

Thus, the existence of large potential gains resulting from the increased competition that bank deregulation will supposedly bring about is not very well documented. Indeed, some of the evidence indicates just the opposite. Having said this, we are well aware of the recent developments in banking that make opposition to interstate banking practically moot. The wholesale circumvention of banking laws that has been going on in recent years represents as great a danger to small business as if the Glass-Steagall and McFadden Acts were repealed outright, because it has occurred outside of the public policy process and away from the control of our elected representatives. If interstate banking is to become a reality--in many ways it already is--and the line between banking and commerce is to be altered or erased, Congress must pass legislation that deals with the problems attendant in deregulation.

During these hearings, we have heard the large banks and their holding companies call for a level playing field--a phrase which is already a cliche. But one might well ask: a level playing field for whom? They mean a level playing field for themselves and the huge financial services firms--Merrill-Lynch, Shearson-American Express, Sears, Prudential, and others. But what about the small banks? Will they be able to play on this level field? And what about small businesses engaged in a line of commerce that the banks are seeking to enter? Will an independent insurance or real estate agency or stock broker be competing on a level playing field with banks, which have a natural aura of credibility, the implied security of government insurance, and the automatic tie-ins to an existing client base? We don't think so.

In fact, the matter of possible anti-competitive tie-ins as banks begin to sell insurance, securities, real estate and the like deserves close attention. We've heard a lot recently about the benefits to consumers of having one-stop financial supermarkets. But will the effect truly be to increase competition and lower consumer costs? A consumer that goes to a bank for a mortgage, for example, may feel compelled to purchase home insurance from the bank regardless of what it costs if he or she feels it will help their chances of getting the loan. And of course, a small real estate firm in need of a commercial loan may have to ask for credit from a bank that is its competitor. These are not healthy competitive situations.

Let's look at two ways in which small independent banks are not on a level with the large banks. There are certainly others. All of those on the committee are familiar with the Joint Committee on Taxation's recent report on the taxation of large banks, which showed the very largest banks to have paid taxes at the rate of 2.3 percent on income earned in the U.S. in 1981. Of course this study is somewhat superficial. Yet for comparison purposes, a recent study by the Independent Bankers Association of America is worth noting. This study showed that banks with under $100 million in deposits--and there are almost 13,000 of them--in 1981 paid an effective tax rate of between 17.3 percent and 21.1 percent. Banks with deposits between $100 million and $1 billion paid effective tax rates of between 9.0 percent and 11.6 percent. Thus it appears that large banks are accorded favorable tax treatment that may provide a competitive edge over small independent banks. If what we are seeking is a level playing field, perhaps something ought to be done about the taxation of banks.

A second area where small banks appear to be on something other than a level playing field is capital adequacy requirements. The large money center banks have been largely free of capital standards set by the regulatory agencies, and in 1974 had sunk to capital of

3.49 percent. The levels have fluctuated between 3.6 percent and 4.0 percent since then, although on June 13 a capital adequacy level of 5 percent was set for the 17 multinational banks by the Fed and the Comptroller. Currently, five of the largest banks are below that level, including Bank of America--the nation's biggest. Yet, small community banks still face stiffer capital requirements than large banks at 6 percent. And, of course, capital standards affect a bank's lending limits. Both FDIC Chairman William Isaac and Comptroller of the Currency C. Todd Conover have supported setting one capital standard for all banks. So if we're going to talk about a level playing field, let's include small banks.

Those who favor deregulation argue that it will increase competition in banking. That may be so in the short run, but the opposite may be true in the longer term. If our aim is to increase competition, something must be done to insure that that is the result. There are several ways to do this. Among these, the best may be to require de novo entry into new geographic markets rather than through acquisition of existing banks. Others include limiting the number of acquisitions, allowing regional interstate banking, and limiting the number or method of interstate operations rather than the location. All of these options should be seriously considered. And, at the very least, there is a need to revise existing antitrust laws or to write new legislation in regard to banks.

In summary, we are not arguing that banking deregulation will ultimately be totally bad for small business. There is not enough solid evidence to make hard and fast conclusions to that effect, although the preponderance of evidence makes the value of some current trends questionable. Nor are we trying to stop the seemingly inevitable trend toward interstate banking or refusing to admit what already exists. What NFIB is saying is that we must not simply open the doors wide and let things take whatever course they may without considering closely some of the issues we have raised here. Look at the tax effect on small versus large banks. Look at different capital requirements and perhaps other regulatory imbalances. Examine the anti-trust laws to see if they will prevent undue concentration in banking. And, monitor the effects of changes on small business and other groups. All of these factors should play an essential part in any legislation that seeks to change a banking system that is so crucial to the financial health of small businesses in America.

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NFIB® CREDIT, BANKS AND SMALL BUSINESS

MAY 1983

FOREWORD

If any single word could describe events in the financial markets over the last five years, it would be "change." The rapid growth of money market mutual funds in response to the removal of Regulation Q ceilings, partial deregulation on the liability side of balance sheets in banking and thrift institutions, the issuance of jumbo CD's tied to Treasury Bill rates, a new monetary policy from the Federal Reserve, the Depository Institution Deregulation and Monetary Control Act of 1980, and historically high and volatile interest rates were just some of the more obvious examples--and more change lay ahead. Because of the importance to small business of the financial markets in general and the banking system in specific, NFIB felt it necessary to assess and report the impact of these changes on smaller firms.

This study, Credit, Banks and Small Business, is primarily based upon two surveys of the same name conducted over random samples of the NFIB membership in April, 1980, and April, 1982. However, data have been integrated from How Small Businesses Begin (November, 1979) and the Quarterly Economic Report for Small Business (quarterly, since October, 1973) to provide a more comprehensive view of the entire small business/commercial bank relationship.

Single copies of this report are available at no charge by writing NFIB.

Research Department

CREDIT, BANKS AND SMALL BUSINESS

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The ability of small business to access credit markets in order to finance new business starts or existing operations is critical to the health of the U.S. economy. Small business produces an estimated 43 percent of the Gross National Product, employs 56 percent of the private workforce, produces a disproportionate share of new jobs and innovations, and often is the "seed" for major industries of the future.[1]

The need to analyze small business and its relationship with financial markets arises from a concern over the adequacy of capital flows to this important sector of the economy. "Conventional wisdoms" of questionable validity frequently appear in the financial press and in policy discussions. For example, it is often asserted that small business is the first group to be rationed out of the market when credit gets "tight." That or similar assertions may or may not be true, but if any hard data underly them, it usually consists of interviews with a few entrepreneurs or impressions of "knowledgeable" people. The unfortunate result is a series of questionable premises underlying a collective frame of reference.

In an environment of "deregulation," the potential effect of liberalized branching laws (i.e. interstate banking) on small businesses' ability to obtain credit is also of major interest. Several studies have suggested that bank customers would be better served with less restrictive branching laws.[2] The conclusions of these studies have been based upon aggregated bank data which typically use a Standard Metropolitan Statistical Area (SMSA) as the relevant market. For most small firms, the SMSA is too large an area to measure relevant bank performance. Furthermore, the use of aggregated bank data precludes analysis of individual loan rates, collateral requirements, problems with credit availability, or assessment of the non-price dimensions of a banking relationship (such as the reliability of banks as a steady source of credit).

This report presents a comprehensive study of small business participation in financial markets. Two surveys of the membership of the National Federation of Independent Business conducted in

April 1980 and 1982 were used as the basis for the study. The surveys provided descriptors of the firm (form of business, industry classification, years in business, sales, employment), data on the most recent loan acquired (size, maturity, interest rate, purpose, collateral), and data about the firm's banking relationship and credit market, including information on credit availability, loan term satisfaction, perceptions of bank competition for its business, and rankings of major bank performance on characteristics deemed important in a banking relationship. There were 2657 respondents to the 1980 survey (a response rate of 33 percent) and 2349 respondents to the 1982 survey (a response rate of 31 percent).

The major findings of this report are:

- Most firms were able to satisfy their financing needs.
- Problems with credit availability were related to characteristics of the firm that in turn are correlated with the risk of default.
- Small firms do not always pay more than the prime rate. Few respondents paid more than 2 points over the prime rate.
- The average rate paid was rarely more than 150 basis points above the prime rate. When the prime was rising (falling), the difference narrowed (widened).
- Differences in rates paid by market size (urban-rural) and branching laws existed in 1980, but were substantially eliminated by 1982.
- Small firms were more likely to be solicited by a bank in metropolitan areas, statewide branching states, and in communities with more than four banks.
- Banks performed best in providing small firms with locational convenience, a wide range of services, and in having a single person to handle the firm's credit needs.
- Banks in unit banking states and rural banks generally performed better than branching states and metropolitan banks on the characteristics most desired in a banking relationship.

The conclusions drawn in this study are probably generalizable to the larger small business population. Comparisons of government data and NFIB samples suggest that, with few exceptions, the NFIB membership (and samples drawn from this membership) are representative of the firms in the U.S. small business sector.

I. Small Business Borrowing

A. Sources of Small Business Loans

The sources of capital for starting a new firm are substantially different from those used by the firm once its business operation is established. The findings from a 1979 study of small business starts are reported in Table 1.3/ Among firms started by their current owners (not inherited or purchased), the study found that 40 percent relied on one major source of credit. Over half of these firms (17 percent of all firms started) reported their own personal resources as the single major source of funds. Nine percent of all firms relied primarily on funds obtained from institutional lenders (principally banks, but some finance and insurance companies). Friends, relatives and unrelated individual investors accounted for the remainder. Government and venture capital firms were negligible sources of funds.

Table 1

SOURCE OF FINANCING NEW SMALL BUSINESS[1]

One Major Source	All Firms	Starts[1]
Personal Savings	17	23%
Friends; Relatives	4	2
Institutional Lender	9	7
Individual Investor	4	3
Venture Capital	*	*
Government	1	1
Other Source	5	4
	40%	40%

Two Major Sources[2]	All Firms	Starts[1]
Personal Savings and:		
Institutional Lender	18%	23%
Friends; Relatives	9	11
Individual Investors	2	2
Friends; Relatives and:		
Personal Savings	5	3
Institutional Lender	4	2
Institutional Lender and:		
Personal Savings	12	11
Friends; Relatives	4	3
	54%	55%
Other Pattern; No Answer	6%	5%
Total	100%	100%
Number of Firms	1805	890

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[1] Firms that were started by their owners (not purchased or inherited).

[2] Most important listed first.

* Less than 0.5 percent.

Source: *How Small Businesses Begin* (November, 1979), National Federation of Independent Business, unpublished.

Most interesting were the firms still owned by the entrepreneurs who started them. Fifty-five percent reported two major sources of funds. For nearly 60 percent of these (36 percent of all starts), personal savings were the major source of capital, in combination with funds from institutional lenders (23 percent of all starts), and with money from friends and relatives (9 percent of all starts). Institutional lenders were the primary sources for nearly 11 percent of the multi-source starts (14 percent of all starts)--almost always in combination with personal savings.

Overall, personal savings played a major role in 63 percent of the new business starts, while institutional lenders were important capital sources in 47 percent of the cases. Friends and relatives were major capital sources in 26 percent of the new ventures.

The pattern was considerably different for firms which were purchased or inherited. The contribution of personal resources in these types of business originations diminished, although personal resources remained important. The primary factor differentiating purchases and inheritances from starts is the enhanced role of lending institutions. Established businesses have a "track record" plus certain other inherent advantages, e.g. an established customer base which reduces lender risk. The lender is more willing to extend loans in such instances.

Once the firm is established, credit needs change, with the emphasis shifting from personal sources to institutional ones--primarily banks. About 85 percent of loans to operating small businesses come from banks, with private individuals accounting for another 5 percent (Table 2). Government sources, finance companies, S&Ls and insurance companies each comprise 1 to 3 percent of the remaining loans.

Over 90 percent of the short-term loans (1-12 month maturity) were from banks. The proportion of loans financed at banks declined as maturity increased, with banks providing over 70 percent of loans with maturities of five years or more. Private individuals and finance companies picked up the share of medium-term loans not made by banks. For the longest maturities, private individuals and S&Ls were more active lenders, with S&Ls providing mostly mortgage financing. Between 1980 and 1982, however, the S&L share of long-term loans fell three percentage points. This reduced financing by S&Ls is attributable to the effect of deregulation on the cost of funds and its effect on commitments for long-term lending.

Government sources provided 4 percent of the long-term loans, the public's highest participation in the financing of operating firms, and proportionately four times larger than its financing role in the starting of new firms. Fifty-five percent of the firms

Table 2

SOURCE OF SMALL BUSINESS CREDIT BY LOAN MATURITY (MONTHS)

	Maturity (Months)						All Loans[2]	
	1 - 12[1]		13-60		Over 60			
Loan Source	1980	1982	1980	1982	1980	1982	1980	1982
Bank	90%	91%	82%	78%	70%	73%	85%	84%
Private Individual	4	4	5	8	9	10	5	6
Government	1	*	2	1	4	4	1	1
Finance Company	1	1	4	5	2	2	2	2
Insurance Company	1	*	1	1	1	2	1	1
Factors/Credit Cards[3]	*	*	*	*	*	*	*	*
Co-op	1	1	1	1	1	1	1	1
Savings & Loan	1	1	1	2	7	4	2	2
Other	1	2	4	4	4	4	4	3
	100%	100%	100%	100%	100%	100%	100%	100%
Number of loans	1170	968	602	605	269	253	2218	1947

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[1] Includes Revolving Credit.

[2] Includes 85 no answers in 1980 and 122 no answers in 1982.

[3] In 1980, "Factors," and in 1982 "Credit Cards" were offered respectively as financing source choices.

* Less than 0.5 percent.

in the 1980 survey reported not knowing of any government small business lending program (Table 3). (The series of questions related to government programs was not repeated in 1982.) Firms were most aware of the SBA (Small Business Administration) guaranteed loan and SBA direct loan programs. Knowledge of Economic Development Administration (EDA) programs was virtually non-existent. Only 5 percent of the firms reported using a government assistance program within three years of the survey. Of those that reported using a program, 68 percent used the SBA guarantee, while 22 percent used the SBA direct loan. Of those that did not use a government assistance program, lack of need was the most frequently reported reason (36 percent), while 19 percent reported that they had never thought about it. Over 25 percent reported that they did not use the programs because of too much red tape, while 10 percent did not use them because of the difficulty in understanding the program procedures. Government-supported small business lending programs were not important to this sample of small firms.

Table 3

USE OF GOVERNMENT ASSISTANCE PROGRAMS

Knew About Assistance Programs		Percent Reporting
Yes		45%
SBA Loan	39%	
SBA Guarantee	47	
EDA Loan	4	
EDA Guarantee	4	
State Loan	6	
No		55%
		100%
Used Assistance Program in Last Three Years		
Yes		5%
SBA Loan	22%	
SBA Guarantee	68	
EDA Loan	2	
EDA Guarantee	5	
State Loan	3	
No		86%
Did not need	36%	
Did not qualify	5	
Money not available	1	
Bank did not participate	4	
Too much paperwork	25	
Program not understandable	10	
Never thought about it	19	
No Answer		9%
		100%

B. Characteristics of Small Business Borrowers

At one time or another most small businesses borrow money. Over 90 percent of all firms have borrowed at some time in their history (Table 4). Over 50 percent of all firms borrow at least once per year. The remainder, about 40 percent, borrow less frequently.

Not all firms have the same capital needs, so borrowing activity will vary substantially by such characteristics as firm size or industry. For example, the proportion of regular borrowers rises from a low of 42 percent for firms with annual sales of $50,000 or less to 68 percent of firms with sales of $3 million or more

(1980). A similar pattern was observed when using total employment and asset size, both generally related to firm sales levels.

Frequent borrowing activity was more likely to occur in firms that have been in business between three and fifteen years. Firms in business under three years pose the highest risk to lenders, while firms in business three years or more typically have passed the critical stage of survival and become better credit risks. Their borrowing frequency then tends to increase, supporting growth after the initial critical period. Firms in business over 15 years have usually made the decision to remain at their current size. With growth stabilized, borrowing needs diminish.

Rapid growth typically requires more capital than the firm can generate internally or the owners can provide. In 1980, 69 percent of the firms with rapidly expanding sales borrowed regularly, compared to 52 percent of the firms with steady growth. The difference was also present in 1982, although borrowing activity was lower for all firms than in 1980. Lower credit demands were due to the recession, lower inventories and the failure of many marginal firms. In both years, borrowing rates for firms with declining sales were higher than for firms with steady sales. This is, in part, a function of the "survival" borrowing resulting from the squeeze imposed on cash flows due to rising costs or declining demand.

Industry credit demands varied widely. The most frequent borrowers were found in construction, transportation, the wholesale trades and agriculture, where fixed capital or inventory requirements are substantial, and/or seasonal factors produce a major mis-match between revenues and costs. Firms in the service industries and retailing were the least frequent "regular" borrowers. These relative differences were present in both 1980 and 1982.

Heavy agricultural borrowing activity helps explain why firms in rural areas exhibited the highest average rate of frequent borrowing in 1980 and 1982. In 1980, firms in metropolitan areas were the most frequent regular borrowers, but the percentage fell from 60 percent in 1980 to 49 percent in 1982. Regional differences in borrowing activity were also substantial. Borrowing activity in both years was highest among firms in the West North Central region, which has an economy heavily dependent upon agriculture. Borrowing activity was consistently higher in the Mountain states and West South Central states than in most other regions, probably reflecting both the high demand for energy related loans and relatively strong overall regional economic growth.

A substantial decline in borrowing activity occurred between 1980 and 1982. The late 1970's were characterized by an economic

Table 4

FIRM CHARACTERISTICS AND BORROWING FREQUENCY

Characteristic	Percent of Firms[1]		Borrowing Activity: Frequent Borrowers[2]		Borrowing Activity: Infrequent Borrowers[2]		Borrowing Activity: Non-Borrowers[2]	
	1980	1982	1980	1982	1980	1982	1980	1982
All Firms	100%	100%	56%	52%	35%	41%	8%	6%
Gross Sales: (thousand $)								
under 50	8	8	42	39	44	50	14	11
50-99	11	11	50	51	42	40	8	9
100-200	17	15	57	47	34	46	9	7
200-350	15	15	53	49	37	45	10	6
350-500	9	10	59	57	34	40	7	3
500-800	9	10	56	51	37	43	7	6
800-1,500	12	12	66	61	28	36	6	3
1,500-2,999	7	8	64	62	31	35	5	3
3,000 or more	9	10	68	63	30	33	2	4
Fulltime Employment:								
one	10	7	50	43	34	45	16	12
two	10	9	53	46	38	48	9	6
3-5	29	28	53	49	38	43	9	8
6-9	18	18	55	54	38	42	7	4
10-14	10	11	61	57	31	38	8	5
15-19	5	5	64	59	29	38	7	3
20-39	9	9	67	61	30	38	3	1
40 or more	9	8	64	60	33	34	3	6
Years in Business:								
1-2	9	6	44	51	44	42	12	7
3-4	12	10	61	58	31	36	8	6
5-6	9	9	62	59	31	35	7	6
7-10	16	16	60	54	34	41	6	5
11-15	12	12	64	54	30	40	6	6
16-20	10	9	57	52	36	44	7	4
Over 20	32	37	52	50	38	44	10	6
Annual Average Sales Growth[3] (Past 2-3 Years)								
Over 20% (rapid)	10	15	69	60	28	34	3	6
11-20% (growing)	46	16	60	53	34	43	6	4
6-10% (growing)		22		51		42		7
0-5% (steady)	26	20	52	49	41	47	7	4
Declined	11	19	58	57	34	38	8	5
Too New to Measure	2	4	39	47	48	46	3	7

Table 4 (continued)

Characteristic	Percent of Firms 1980	Percent of Firms 1982	Borrowing Activity: Frequent Borrowers 1980	Frequent Borrowers 1982	Infrequent Borrowers 1980	Infrequent Borrowers 1982	Non-Borrowers 1980	Non-Borrowers 1982
Industry:								
Construction	15	15	68	63	24	31	8	6
Manufacturing	12	12	56	51	39	43	5	6
Transportation	3	3	70	63	23	37	7	0
Wholesale	8	8	61	54	33	43	6	3
Retail	33	33	52	49	38	45	9	6
Agriculture	5	5	73	74	21	21	6	5
Financial	8	7	56	48	31	44	13	8
Service	10	11	41	43	50	48	9	9
Professional	6	6	51	49	43	44	6	7
Value of Assets: (thousand $)								
Under 25	na	6	na	43	na	45	na	12
25-49		7		46		48		6
50-99		15		48		46		6
100-249		21		54		41		5
250-499		16		58		38		4
500-999		11		62		33		5
1,000-4,999		9		62		36		2
5,000 or more		2		70		26		4
Location:								
Rural	40	41	59	54	34	40	7	6
Small City	30	30	56	53	36	42	8	5
City	19	20	54	51	38	43	8	6
Metropolitan	8	8	60	49	35	46	5	5
Region[4]:								
New England	5	5	44	47	50	48	6	5
Mid-Atlantic	10	10	52	47	42	44	6	9
E. N. Central	16	18	59	51	35	44	6	5
W. N. Central	13	14	62	64	31	33	7	3
S. Atlantic	10	11	51	47	38	46	11	7
E. S. Central	4	4	52	49	42	44	6	7
W. S. Central	11	11	63	58	31	37	6	5
Mountain	9	9	61	61	30	33	9	6
Pacific	18	18	54	46	34	46	12	8

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[1] Does not add to 100% since firms not reporting a value for each characteristic are omitted.

[2] Frequent borrowers: at least one time per year; infrequent borrowers: less than once per year; non-borrowers' no borrowing reported at any time.

[3] In 1980, only the verbal categories were used.

[4] Department of Commerce classifications.

na not asked.

expansion accompanied by unusually high inflation and interest rates. Total borrowing in the economy expanded rapidly, and small business was no exception. The percent borrowing at least once every three months increased 10 percentage points (from 40 to 50 percent) between 1977 and early 1980 (Table 5). Borrowing activity has declined since that time, except during the brief expansion after the major economic downturn in the second quarter of 1980. By early 1982, quarterly borrowing had dropped ten percentage points to 40 percent of all firms, a level of activity typical of small business borrowing as the economy emerged from the 1974-75 recession.

Table 5

BORROWING BEHAVIOR OF ALL FIRMS

Year/ Quarter	Percent Borrowing[1]	Year/ Quarter	Percent Borrowing[1]	Year/ Quarter	Percent Borrowing[1]
1973 III	40	1977 I	40	1980 I	50
IV	39	II	41	II	41
		III	40	III	43
1974 I	41	IV	38	IV	45
II	45				
III	42	1978 I	47	1981 I	44
IV	38	II	47	II	45
		III	46	III	43
1975 I	42	IV	51	IV	40
II	39				
III	39	1979 I	na	1982 I	40
IV	39	II	46	II	41
		III	48	III	42
1976 I	39	IV	46	IV	40
II	39				
III	40				
IV	40				

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[1] Percent of all firms, borrowing at least once every three months. Surveys are taken in the month following each quarterly period.

na not asked.

Source: Quarterly Economic Report for Small Business, National Federation of Independent Business, various editions.

II. Small Business Loan Characteristics

A. Size

In both surveys, almost half of the loans were under $20,000. Loan size was related to maturity. Short- and medium-term loans were the smallest, with about 50 percent amounting to less than $20,000. Long-term and revolving credit loans were the largest. Over 50 percent of the revolving credit loans were in excess of $100,000, and over 60 percent of the long-term loans were in excess of $40,000.

The average loan size increased by almost $6,000 between 1980 and 1982 (Table 6). This increase, 4 percent compounded annually, was less than the rate of inflation. Thus, the average real amount borrowed fell. All of the increase in the average loan size was due to an increase in the size of long-term loans, which rose by 16 percent per year. Short-term loans remained at about the same level. The average medium-term loan fell by 5 percent per year, and revolving credit loans fell by 7 percent per year. Most of the increase in the long-term loan size was due to the increased incidence of property and expansion loans, which generally were larger.

Loan size increased with firm sales, reflecting the additional debt capacity of larger firms (Table 7). Forty eight percent of the firms with sales in excess of $1.5 million per year reported loans in excess of $100,000 versus only 4 percent with sales under $100,000 per year. Loan size also varied with degree of investment in long-lived assets. Agricultural and transportation firms more frequently reported loans over $100,000, reflecting their greater investment in long-lived capital equipment. Professional, non-professional, and financial service firms, with relatively little plant and equipment and inventory, more frequently reported loans under $10,000.

B. Maturity

About half of the loans in each survey were short-term, i.e. a reported maturity of twelve months or less (Table 8). Revolving lines of credit comprised only four percent of the reported loans in 1980 and three percent in 1982. Medium-term loans (13 to 60 months) were reported by about 30 percent of the firms in both surveys; long-term loans (61 months or more) were reported by about 12 percent of the firms.

Although the incidence of frequent borrowing fell between 1980 and 1982, a higher proportion of the firms responding to the 1982 survey had been recent participants in the credit market. In the April 1980 survey, 74 percent of those that reported a short-term loan had obtained the loan within a year of the survey; this

Table 6

LOAN SIZE BY LOAN MATURITY

Loan Size: (thousands $)	All Loans 80	All Loans 82	Short-Term 80	Short-Term 82	Medium-Term 80	Medium-Term 82	Long-Term 80	Long-Term 82	Revolving Credit 80	Revolving Credit 82
Under 5	14%	13%	67%	59%	26%	32%	1%	1%	1%	2%
5-9	16	15	57	47	31	44	4	3	2	1
10-19	18	21	57	49	28	37	7	6	4	2
20-39	20	17	51	49	28	28	15	13	3	3
40-69	12	11	43	48	31	24	19	17	3	3
70-99	4	4	41	37	29	34	27	23	2	1
100-149	5	6	41	28	24	26	20	35	11	1
150-199	2	3	35	45	17	16	33	22	9	9
200-299	3	3	34	32	23	20	28	33	11	6
300-399	1	1	47	46	13	14	28	25	9	7
400-599	2	3	29	37	27	15	22	33	22	4
600-999	1	1	32	24	12	16	24	44	24	12
1,000-2,000	1	1	31	33	19	8	25	42	13	0
Over 2,000	*	1	50	10	10	20	30	40	10	10
All Firms	100%	100%	52%	47%	27%	31%	12%	13%	4%	2%

Maturity	Mean Loan Size 1980	Mean Loan Size 1982	Median Loan Size 1980	Median Loan Size 1982
1-12 months	$ 54,950	$ 54,130	$ 14,580	$ 14,960
13-60 months	55,150	49,840	19,250	13,550
61+ months	145,620	195,950	50,070	78,500
Revolving Credit	201,360	176,860	50,500	40,160
All Loans	$ 72,800	$ 78,630	$ 19,780	$ 19,610

proportion rose to 81 percent in the April 1982 survey. Larger shifts occurred for medium- and long-term loans. The proportion of medium-term loans obtained within a year of the survey rose from 53 percent to 70 percent, and the long term proportion rose from 37 percent to 61 percent.

The maturity composition of the reported loans changed between the surveys (Table 9). Between 1980 and 1982, the proportion of short-term loans made fell six percentage points (from 53 to 47 percent). Within the short-term category for both surveys, over 40

Table 7

FIRM AND LOAN CHARACTERISTICS BY LOAN SIZE

			Loan Size													
	Total		Under $5000		$5000-9999		$10,000-19,999		$20,000-39,999		$40,000-99,999		$100,000-299,999		$300,000 or more	
Characteristics	80	82	80	82	80	82	80	82	80	82	80	82	80	82	80	82
Firm's Annual Sales: (thousand $)																
under 50	7%	7%	46%	42%	19%	24%	13%	19%	14%	9%	4%	4%	2%	1%	2%	1%
50-99	12	11	28	20	27	19	21	24	14	15	6	9	4	3	*	*
100-199	17	16	19	21	28	25	24	26	12	13	11	8	5	6	1	2
200-349	16	15	13	11	18	19	23	26	24	18	14	16	6	8	1	2
350-499	9	10	10	10	16	14	27	30	25	18	14	17	5	8	3	3
500-799	9	10	4	5	10	14	21	26	32	25	20	16	9	12	4	2
800-1,499	12	12	2	2	6	8	16	19	28	27	28	26	17	13	3	5
1,500-2,999	8	8	2	2	4	5	7	12	24	21	31	25	24	26	8	9
3,000 or more	9	9	2	1	4	0	2	3	14	9	16	19	30	32	32	36
No Answer	1	2	14	17	30	17	18	21	25	15	9	24	4	2	0	4
Industry:																
Construction	16	15	10	8	15	14	19	22	18	21	18	16	14	13	6	6
Manufacturing	12	12	10	9	11	9	17	22	19	15	19	19	10	17	12	9
Transportation	3	3	6	0	9	10	25	25	21	18	22	16	12	11	7	20
Wholesale	8	7	4	6	9	7	11	16	24	20	25	22	19	16	9	12
Retail	33	34	18	16	19	17	17	22	20	16	15	15	8	10	3	4
Agriculture	5	5	8	4	10	10	18	12	23	19	18	21	14	23	10	12
Finance	7	7	11	13	22	19	25	17	22	21	8	16	9	9	4	6
Services	10	11	25	30	20	18	20	21	19	13	8	11	5	4	3	2
Professional	6	6	17	15	22	22	23	27	25	18	9	10	2	4	2	2
No Answer	*	*	0	14	20	0	0	14	40	29	20	14	20	0	0	29
Loan Purpose:																
Inventory	25	20	13	12	13	16	17	22	20	20	18	17	10	8	6	5
Tax, Payroll, Debt	27	24	13	18	16	13	21	24	21	22	13	11	8	9	5	2
Maintenance	14	18	17	15	29	19	18	24	16	14	8	12	7	9	2	7
Property	8	7	7	7	11	9	14	16	23	18	19	20	13	21	9	9
Expansion	22	25	10	6	12	13	15	18	22	14	20	18	14	18	6	11
No Answer	4	7	24	18	13	12	14	19	19	21	10	17	12	7	4	4
Total	100%	100%	13%	12%	16%	14%	18%	21%	20%	18%	16%	15%	10%	12%	5%	6%

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* Less than 0.5 percent

Table 8

Year Last Loan Obtained By Loan Maturity

April 1980 Survey	(Months) 1-12	13-60	61 or More	Revolving Credit	All Firms[1]
Date of Loan					
1980 I	42%	21%	14%	54%	33%
1979 IV	16	13	8	8	14
1979 III	8	10	7	10	8
1979 II	8	9	8	8	8
Prior to 1979 II	21	44	56	19	32
Not Ascertained	5	3	7	1	5
Number of Loans	1170	602	269	96	2218
Percent of Total	53%	27%	12%	4%	100%
April 1982					
Date of Loan					
1982 I	45%	29%	15%	23%	33%
1981 IV	17	18	21	15	18
1981 III	10	12	11	8	10
1981 II	9	11	14	13	11
Prior to 1981 II	16	28	36	33	23
Not Ascertained	3	2	3	8	3
Number of Loans	916	605	253	52	1948
Percent of Total	47%	31%	13%	3%	100%

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[1] Includes 85 "no answers" in 1980 and 122 "no answers" in 1982.

percent of the loans were three months or less, and the mean maturity was about six months. Most of the drop in short-term loans was offset by gains in medium-term maturities. Medium-term maturities increased from 27 percent to 31 percent of all loans. Although the average maturity remained at 41 months in both years, the medium-term maturities reported in 1982 increased in the "25-36" month category by five percentage points and decreased four percentage points in the "49-60" month category. The proportion of long-term loans increased slightly from 12 to 13 percent, but the average maturity increased by almost 15 months between 1980 and 1982. This average maturity increase was largely due to a jump in the proportion of 30 year loans made (not shown in Table 8), rising from 3 to 9 percent of the total long-term loans. Despite the jump in average maturity for long-term loans, the median maturity remained unchanged.

The more recent credit market participation of small business borrowers in the April, 1982, survey was likely attributable to slower overall economic activity and continued high interest rates. Lower inflation and reduced demand forced firms into price cutting, which in turn reduced cash flow. Breaking a pattern established in previous downturns, interest rates did not fall significantly (or at least back to their mid-70's level), further exacerbating small business cash flow problems. This resulted in heavier borrowing to maintain liquidity.

Table 9

LOAN MATURITY

Maturity (months)	Short-Term		Medium-Term		Long-Term	
	80	82	80	82	80	82
1-3	45%	42%				
4-6	28	31				
7-12	27	27				
13-18			5%	4%		
19-24			21	20		
25-36			32	37		
37-48			11	12		
49-60			31	27		
61-96					32%	28%
97-120					35	31
121-180					20	20
181 or more					13	21
Mean Maturity	5.9	6.1	41.2	40.6	140.6	155.4
Median Maturity	5.5	5.7	36.2	36.2	120.0	120.2

The increased frequency of medium and long-term borrowing within a year of the survey did not, however, reflect an attempt by small business to restructure its balance sheet (i.e. convert short-term debt into long-term debt). Instead, this increased medium and long-term borrowing was used for maintenance, property acquisition, and expansion. The proportion of loans used for these purposes rose from 44 percent to 50 percent between surveys. Apparently these firms had profitable investment opportunities and were not going to wait for improved sales to provide sufficient internal cash, or were firms less affected by the down-turn in the economy.

The maturity of the loans were closely matched to their primary use (Table 10). Short-term loans were used primarily for inventory and current liability financing, medium-term loans for maintenance and expansion and long-term loans for property acquisition and expansion. Despite the considerable maturity matching, many small firms used short-term sources of funds for long-term uses. The percentage using short-term funds for long-term purposes jumped between 1980 and 1982. For example, 15 percent of the firms in 1980 used short-term loans to finance property and expansion, while 18 percent did so in 1982. Although this strategy is very risky, these "mis-matched" firms either bet short-term rates would fall in the near future (once rates fell they could refinance long-term and pay a lower average interest cost) or they could not obtain long-term funds indicative of higher risk of default.

Table 10

LOAN MATURITY BY LOAN PURPOSE

			Loan Purpose									
	All Firms		Inventory		Tax, Payroll Debt		Maintenance		Property		Expansion	
Maturity	80	82	80	82	80	82	80	82	80	82	80	82
Short-Term (1-12 mos)	57%	50%	35%	29%	36%	35%	9%	12%	4%	5%	11%	13%
Medium-Term (13-60 mos)	27	31	10	10	17	13	27	31	8	6	34	35
Long-Term (over 60 mos)	12	13	6	6	13	7	10	15	23	15	45	47
All Firms	100%	100%	25%	20%	27%	24%	14%	18%	8%	7%	22%	25%

C. Collateral Requirements

Some form of collateral was required on 62 percent of the loans reported in 1980 and 64 percent of the loans in 1982 (Table 11). Collateral was most frequently reported by firms in the manufacturing, wholesale and agricultural industries, and least frequently reported by firms in the financial and professional services. These industry differences can be partly explained by the relative marketability of the assets serving as collateral. Manufacturing, wholesaling, and agricultural firms usually have plant, equipment, or inventory that could be sold in the event of default. Financial service (primarily real estate and insurance agents) and professional service firms, however, have few marketable assets.

Use of collateral varied by type of lender. Loans from individuals and insurance companies (possibly policy loans) were least frequently secured, while loans from commercial banks were more frequently secured. This difference is not surprising because of the time and expense involved in creating the secured lending agreement and monitoring the use of the collateral. Lenders that do not have experience in making secured loans (e.g. individuals, insurance companies making policy loans) would find the cost exceeding the benefits. The advantage of securing a loan with business or personal collateral is that the lender obtains first claim on those assets in the event of bankruptcy.

This relationship between risk and the frequency of issuing secured debt can been seen in Table 11. As loan size increases, all else being equal, the borrower's leverage increases, thereby increasing the risk to the lender. Accordingly, only 36 percent of the loans under $5000 were reported collateralized, while over 80 percent of the loans exceeding $300,000 were. Collateral was required for about half of the short-term loans, rising to almost 90 percent of the long-term loans. Longer term loans present more risk to the lender if repayment comes from the future earnings power of the firm rather than its ability to sell current inventory or receivables. Newer firms, which are more likely to default, have a higher incidence of secured loans. Almost 70 percent of the firms less than four years old had collateral required, but only 50 percent of those firms in business over 20 years reported a collateral requirement for their loan.

Business assets were most often used as collateral, followed by a combination of business and personal assets (Table 12 and 13). Plant and equipment was most frequently used as business collateral (51 percent), followed by inventory (28 percent), and accounts receivable (17 percent). Homes (37 percent) and securities (17 percent) accounted for over half of the personal collateral, with the remainder taking some other form.

Table 11

COLLATERAL REQUIREMENTS BY SELECTED VARIABLES

	Percent of All Firms		Percent with Collateral	
	1980	1982	1980	1982
Loan Maturity:				
1-12 months	56%	51%	49%	52%
13-60 months	27	29	73	67
61 months or more	10	11	89	87
Revolving Credit	4	3	67	55
Loan Size: (thousand $)				
Under 5	13	12	36	37
5-9	15	15	52	47
10-19	19	21	56	61
20-39	21	18	65	65
40-99	16	15	71	70
100-299	10	12	76	76
300 or more	5	6	83	82
Years in Business:				
1-2	8	6	71	71
3-4	12	10	68	76
5-6	9	9	64	66
7-10	17	17	67	64
11-15	13	12	61	67
16-20	10	9	60	54
over 20	30	36	49	52
All Firms	100%	100%	62%	64%

Use of accounts receivable, inventory, and plant and equipment as collateral was related to the borrower's industry, loan source, and maturity of the loan. Manufacturing, transportation, and non-professional service firms most frequently provided plant and equipment as collateral; retail and wholesaling firms most frequently provided inventory; and construction, financial, and professional services most frequently provided accounts receivable. Loans from the government and finance companies were more likely to require plant and equipment as collateral than inventory. Finally, short-term loans were more likely to be collateralized by accounts receivable and inventory, while long-term loans were more likely to be collateralized by plant and equipment--a result consistent with the maturity-loan purpose relationship discussed above.

Table 12

COLLATERAL REQUIREMENTS BY SELECTED VARIABLES

	Total		None		Business		Personal		Business and Personal		Compensating Balances		Other Combinations	
	80	82	80	82	80	82	80	82	80	82	80	82	80	82
Loan Maturity:														
Short-term	57%	50%	47%	43%	23%	25%	9%	2%	13%	18%	3%	5%	5%	6%
Medium-term	27	31	28	35	36	32	10	5	18	20	1	2	6	7
Long-term	12	13	13	15	37	39	11	8	29	28	2	3	8	7
No Answer	4	6	44	30	25	25	11	3	14	26	*	4	6	11
Industry:														
Construction	16	15	38	36	29	29	8	5	17	20	2	4	5	7
Manufacturing	12	13	32	34	28	32	9	1	20	20	3	4	8	9
Transportation	3	3	42	38	37	31	3	2	15	15	*	5	3	9
Wholesale	9	8	33	30	26	29	8	3	22	23	2	5	7	9
Retail	32	33	38	37	26	29	11	4	18	21	2	3	5	6
Agriculture	5	5	28	31	49	41	1	2	14	17	2	1	6	8
Finance	8	7	48	41	22	17	12	7	7	21	3	8	8	6
Services	9	10	37	37	28	26	13	5	15	22	2	4	5	6
Professional	6	6	44	41	31	32	11	3	10	16	2	2	2	5
No Answer	*	*	20	*	20	1	*	*	40	*	20	*	*	17
Loan Source:														
Bank	85	84	37	35	28	30	10	4	17	21	2	4	6	7
Individual	5	6	59	56	22	14	5	3	11	15	2	3	1	9
Government	1	1	4	22	52	39	*	11	40	17	*	6	4	6
Finance Co.	2	2	33	29	26	32	14	10	26	27	2	*	*	2
Insurance	1	1	55	53	5	27	5	*	30	7	*	7	5	7
Factor	*	*	25	*	50	*	*	*	*	*	*	*	*	*
Co-op	1	1	12	24	56	53	8	*	16	18	4	*	*	6
S & L	2	2	21	22	27	19	32	16	6	41	3	*	12	3
Other	2	2	32	29	43	43	4	*	15	16	*	4	7	8
No Answer	1	1	57	50	24	43	5	*	*	*	5	*	5	7
All Firms	100%	100%	38%	36%	28%	29%	9%	4%	17%	20%	2%	4%	6%	7%

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* Less than 0.5%

Table 13

FORM OF COLLATERAL REQUIREMENTS BY SELECTED VARIABLES

	Business Collateral					Personal Collateral				
	Total	Accounts Receivable	Inventory	Plant and Equipment	Don't Know	Total	House	Stock	Other	Don't Know
Industry:										
Construction	15%	28%	25%	44%	3%	15%	44%	6%	45%	5%
Manufacturing	14	15	12	70	3	12	40	21	37	2
Transportation	3	9	16	75	*	3	29	*	71	*
Wholesale	8	19	42	38	1	8	34	19	45	2
Retail	33	11	44	41	4	35	38	19	39	4
Agriculture	7	16	29	52	3	4	20	20	56	4
Finance	5	24	11	61	4	8	31	18	51	*
Services	9	16	13	69	2	10	41	23	34	2
Professional	5	31	7	56	6	5	28	10	59	3
No Answer	1	20	20	60	*	*	*	100	*	*
Loan Source:										
Bank	85%	18%	29%	50%	3%	85%	37%	17%	43%	3%
Individual	4	18	23	59	*	5	37	11	48	4
Government	1	17	8	67	8	1	67	17	16	*
Finance Co.	3	4	18	67	11	3	47	5	32	16
Insurance Co.	1	*	*	100	*	*	*	*	100	*
Co-op	1	18	36	36	10	1	*	25	75	*
S & L	2	17	22	56	5	3	53	16	31	*
Other	3	10	32	58	*	2	*	20	80	*
Loan Maturity:										
Short-term	42%	28%	38%	32%	2%	42%	28%	20%	49%	2%
Medium-term	33	8	20	67	5	31	37	16	44	3
Long-term	18	7	15	75	3	18	59	11	27	3
No Answer	7	24	38	33	5	9	33	19	44	4
Total	100%	18%	28%	51%	3%	100%	37%	17%	43%	3%

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*Less than 0.5 percent

D. Lines of Credit and Compensating Balances

For frequent borrowers a business lending arrangement such as a pre-approved line of credit gives the borrower more flexibility with loan take-downs and repayments. The flexibility provided by the line of credit does not come free to the borrower, however. The lender is compensated through fees (a certain percentage of the unborrowed amount) or compensating balances (a required percentage of the total line that must be taken down and kept in a demand deposit account).

Preapproved lines of credit were reported by only 32 percent of the firms with loans outstanding (Table 14). Construction, wholesaling, and agricultural businesses most frequently reported lines of credit, while service and professional firms used lines less often (under 20 percent of the firms). Line of credit usage and the size of the line rose with borrowing frequency. This industry effect is largely due to borrowing frequency. Agriculture, wholesaling, and construction firms most often reported borrowing at least once per year. Line of credit usage and the size of the line predictably rose with firm size and loan size. Lines of credit were most frequently reported for short-term loans (40 percent) and were least prevalent for long-term financing.

Compensating balances were required on only 10 percent of the loans (Table 15). The incidence of balances was unrelated to firm size, although larger firms typically reported larger required balances. Balance requirements not surprisingly rose with loan size, since requirements are often computed on the basis of the total credit line or amount used. Loan maturity was unrelated to the use of compensating balances.

The usage of credit lines and compensating balances did vary with bank size, the degree of urbanization in the borrower's market, and branching status in the borrower's state of residence (Table 16). Lines of credit were more frequently reported in metropolitan bank markets, from banks with assets over $500 million, and in states with unit or limited branching. Neither bank size nor branching status were related to the incidence of compensating balances, but they were more frequently reported from borrowers in metropolitan areas.

E. Interest Rates

The average interest rate paid by small business borrowers is shown in Table 17 by maturity and date of origination. For all maturities, interest rates have risen substantially since 1974. Rates charged on short-term loans rose far faster than rates on long-term loans, reflecting the inverted yield structure that

Table 14

PRE-APPROVED LINES OF CREDIT BY SELECTED VARIABLES

		Credit Limit					
	None	Under $5000	$5000-24,999	$25,000-49,999	$50,000-99,999	$100,000-199,999	$200,000 or more
Industry:							
Construction	56%	3%	4%	10%	11%	7%	6%
Manufacturing	69	6	5	2	4	4	10
Transportation	69	*	10	5	3	4	9
Wholesale	59	4	5	4	7	5	16
Retail	71	4	6	5	6	3	5
Agriculture	53	4	5	7	7	8	16
Finance	73	4	2	11	5	2	3
Services	81	4	8	3	1	1	2
Professional	82	3	5	1	3	2	4
Annual Sales: (thousands $)							
under 50	82	7	6	2	1	*	2
50-99	76	6	10	4	3	1	*
100-199	74	3	9	5	5	3	1
200-349	74	2	7	7	4	2	4
350-499	67	3	6	7	8	4	5
500-799	68	4	7	6	8	4	3
800-1,499	61	3	5	7	10	7	7
1,500-2,999	51	2	2	6	10	11	18
3,000 or more	57	6	1	1	3	6	26
Loan Size:							
Under $5000	77	9	11	2	1	*	*
$5000-9999	74	5	12	6	2	*	1
$10,000-19,999	75	2	8	6	6	2	1
$20,000-39,000	67	2	4	11	7	5	4
$40,000-99,999	60	2	1	5	14	7	11
$100,000-299,999	58	6	*	*	6	11	19
$300,000 or more	54	5	1	1	2	3	34
Borrowing Frequency: (times per year)							
None	78	4	4	4	4	2	4
1	71	4	6	5	5	4	5
2	65	2	9	6	7	5	6
3 or more	48	5	6	7	10	6	18
Loan Maturity: (months)							
1-12	60	4	7	7	8	6	9
13-60	78	5	5	4	4	2	3
61 or more	82	3	2	1	4	4	5
All Firms	68%	4%	6%	5%	6%	4%	7%

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* Less than 0.5 percent

Table 15

COMPENSATING BALANCES BY SELECTED VARIABLES

			Size of Balance			
	All Firms	Balance Requirements	Under $3000	$3000-$14,999	$15,000 $24,999	$25,000-plus
Annual Sales: (thousands $)						
under 50	7%	10%	7%	1%	2%	*
50-99	11	12	9	1	1	1
100-199	15	10	5	2	2	1
200-349	15	9	5	2	1	1
350-499	10	8	4	2	1	1
500-799	9	10	5	4	1	*
800-1,499	9	10	4	2	3	1
1,500-2,999	12	11	4	3	3	1
3,000 or more	10	12	2	1	2	7
Loan Size:						
under $5000	12	10	9	*	1	*
$5000-9999	14	9	6	2	1	1
$10,000-19,999	21	9	5	3	1	*
$20,000-39,999	18	9	5	2	1	1
$40,000-99,999	15	6	2	2	1	*
$100,000-299,999	12	12	3	3	4	2
$300,000 or more	6	17	1	2	3	11
Line of Credit						
None	68	7	4	2	1	1
Under $5,000	4	23	13	4	4	1
5,000-24,999	6	20	13	3	4	0
25,000-49,999	5	13	6	3	2	2
50,000-99,999	6	9	4	3	2	1
100,000-199,999	4	10	2	2	4	2
200,000 or more	7	18	1	3	5	9
All Firms	100%	10%	5%	2%	2%	1%

---

* Less than 0.5 percent

prevailed in the late 1970's. In the first quarter of 1980, the average short-term rate paid was 16.9 percent, 240 basis points (2.4 percentage points) above the average rate on long-term loans taken out during the same period. In April, 1982, the average rate paid on both short- and long-term loans was higher than that reported in April, 1980, although the differential between short- and long-term

Table 16

LINES OF CREDIT AND COMPENSATING BALANCES BY SELECTED VARIABLES

	Percent With Lines of Credit	Percent With Compensating Balances
Bank Size: (Millions)		
Under 100	29%	9%
100-500	35	10
Over 500	33	10
Don't Know	19	16
Market Size:		
Rural	31	9
Small City	32	10
City	31	10
Metropolitan	37	14
State Branching Law:		
Statewide	28	8
Limited	34	11
Unit	33	11
All	32%	10%

loans had narrowed substantially. This narrowing differential was consistent with the yield curve at the time of the survey when the prime rate was at 16.50 percent, and the corporate Baa bond rate was at 13.24 percent.

The 1982 survey specifically identified those borrowers with loans tied to the prime rate. Almost 28 percent paid interest rates (on loans of all maturities) tied to the prime. The Quarterly Economic Report has also identified the proportion of short-term loans tied to the prime rate beginning in April, 1982. This proportion has ranged from 32 percent to 38 percent in the October 1982 report (Table 18). The proportion of short-term loans tied to the prime rate in the April, 1982 Credit, Banks and Small Business survey was 30 percent.

The data certainly do not support the conclusion that most small businesses borrow at rates substantially above the prime rate. Only two percent reported short-term rates greater than prime + 2 (less

Table 17

AVERAGE INTEREST RATES[1] PAID BY MATURITY

Date of Loan		Number of Cases	Maturity (Months) 1-12[2]	13-60	Over 60
April 1980:	1974 or earlier	114	7.6%	8.5%	7.2%
	1975	30	8.9	8.6	8.3
	1976	53	8.8	9.2	11.3
	1977	85	9.6	10.9	10.1
	1978	194	10.4	11.3	10.3
	1979 I	103	12.2	12.7	11.5
	1979 II	159	12.7	13.0	12.6
	1979 III	169	12.5	12.8	12.2
	1979 IV	274	14.4	14.0	13.2
	1980 I	620	16.4	15.2	14.0
April 1982:	1981 I	137	16.0	15.7	14.9
	1981 II	156	16.1	15.9	14.2
	1981 III	173	17.4	16.2	14.1
	1981 IV	297	17.5	16.5	14.2
	1982 I	592	17.7	17.3	16.9

---

[1] If the loan rate was tied to the prime rate, the prime rate applicable at the date of origination was used.

[2] Included revolving credit.

than one and a half percent in the 1982 *Credit, Banks and Small Business* Survey). The average rate paid on short-term loans has generally been above the prime rate. This difference has been the greatest when the prime rate was falling (81:4, 82:3) and the least (even negative) when the prime rate was rising (81:2, 80:1).

Rates paid for large loans were generally higher than those paid on small loans (Table 19), suggesting that any scale economies accrued from making the larger loan were offset by increased risk of higher leverage in the borrowing firm's portfolio. Secured loans had higher interest rates across all maturities, but the difference narrowed between 1980 and 1982. Although collateral reduces the potential foreclosure costs of the loan to the lender by giving first priority to the assets in the event of bankruptcy, a secured loan is more costly to administer than an unsecured loan. Thus,

Table 18

INTEREST RATES PAID ON SHORT TERM LOANS
(12 Months or Less)

					#New Series[1]		
Rate Paid	81:1	81:2	81:3	81:4	#82:1	82:2	82:3
Under 13%	3%	1%	2%	2%	# 1%	1%	1%
13 - 15%	15	5	3	7	# 5	4	19
16 - 18%	46	34	30	57	# 50	52	37
19 - 22%	27	48	56	25	# 11	11	5
23% or More	1	5	3	2	# 1	*	*
Prime, +1	4	4	4	4	# 17	18	23
Prime +2	3	2	2	2	# 13	12	12
Prime +3 or More	1	1	*	1	# 2	2	3
	100%	100%	100%	100%	#100%	100%	100%
Average Rate	19.3%	17.9%	17.8%	17.6%	15.4%	14.1%	13.5%
Prime Rate at End of Quarter	18.5%	15.8%	16.5%	16.0%	12.0%	11.0%	10.5%

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[1] Beginning in 1982, the category "prime + ____" was added to the interest rate question.

* Less than 0.5 percent

Source: Quarterly Economic Report for Small Business (National Federation of Independent Business), various editions.

while the cost reduction should reduce the contract rate on a loan, the additional administrative costs raise them. Secured loans would most likely be issued to riskier borrowers where the value of the cost reduction exceeds the increase in administrative costs. Thus, risky borrowers would most likely find the interest rate on secured loans lower than on unsecured loans, while other borrowers would find unsecured loans preferable.

Corporate borrowers typically paid higher rates than unincorporated borrowers for all loan maturities prior to early 1980. Several

Table 19

AVERAGE INTEREST RATES PAID BY LOAN AND FIRM CHARACTERISTICS

Characteristics	Short-Term 1980[1]	Short-Term 1982[2]	Medium-Term 1980[1]	Medium-Term 1982[2]	Long-Term 1980[1]	Long-Term 1982[2]
Loan Size:						
under $5,000	14.4%	17.2%	14.3%	17.1%	--	--
$5,000-10,000	14.1	16.6	13.9	16.6	12.7	16.7
$10,000-20,000	14.4	17.3	13.8	16.2	11.7	18.1
$20,000-40,000	15.0	17.7	12.9	16.3	13.1	14.9
$40,000-99,000	15.6	18.0	14.3	17.0	12.3	13.4
$100,000-300,000	16.4	17.0	14.6	16.4	13.2	14.7
$300,000 or more	16.2	18.0	15.5	17.1	14.5	15.1
Collateral Required:						
No	14.2	17.1	13.4	16.2	12.1	13.7
Yes	15.6	17.6	14.1	16.7	13.0	15.0
Form of Business:						
Corporate	15.4	17.3	14.3	16.7	13.4	14.8
Partnership	13.7	18.2	13.9	17.0	11.0	13.4
Proprietorship	14.3	17.2	13.3	16.2	12.3	15.3
Region:						
New England	16.3	17.1	13.7	17.0	15.4	15.4
Mid Atlantic	14.7	16.1	12.8	16.7	12.0	15.3
E. N. Central	14.6	17.0	14.4	17.0	13.9	14.3
W. N. Central	14.5	17.2	13.4	15.4	11.7	14.8
South Atlantic	14.4	16.9	13.0	15.2	13.2	16.9
E. S. Central	14.6	17.6	13.4	16.8	13.0	15.4
W. S. Central	14.6	17.6	13.8	16.4	12.9	14.6
Mountain	15.4	18.7	13.9	17.7	13.4	13.7
Pacific	15.9	17.9	15.3	17.0	11.7	14.4
Bank Asset Size: ($ million)						
Under 100	14.5	17.2	13.5	16.1	12.9	15.0
100-499	15.0	17.8	13.6	16.4	13.0	14.9
500 or more	15.8	17.2	14.5	16.9	12.9	14.1
Market Size:						
Rural	14.3	17.0	13.6	16.5	12.8	14.5
Small City	15.1	17.5	13.9	16.8	13.0	14.9
City	14.2	18.0	12.9	16.3	15.9	16.4
Metropolitan	15.4	17.7	14.4	16.7	13.2	13.4
State Branching Law:						
Unit	14.8	17.3	13.6	16.6	12.9	14.8
Limited	14.7	17.2	13.7	16.3	13.0	14.8
Statewide	15.4	17.3	14.5	16.7	12.8	15.0

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[1] Includes only those loans originated during the fourth quarter of 1979 and the first quarter of 1980.

[2] Includes only those loans originated during the fourth quarter of 1981 and the first quarter of 1982.

factors potentially contributed to this differential. First, corporate borrowers tend to be larger and more frequently take out larger loans which carried higher interest rates during the period. Second, in the event of default, liability is limited to the extent of corporate assets, while for unincorporated borrowers, the owner's personal assets as well as the assets of the business are legally available to settle the debt (subject to exemptions enumerated in state and Federal law).

The corporate/non-corporate difference in interest rates paid diminished in 1982. One likely explanation is the changed U.S. bankruptcy code, effective October 1, 1979, which expanded the amount of personal assets exempt from bankruptcy proceedings, automatically stayed efforts to recover property once a filing for bankruptcy was made, and made it easier for proprietorships with unsecured debt under $100,000 to proceed into Chapter 13 bankruptcy. These changes in the bankruptcy code may have increased uncertainty over the lender's ability to obtain personal assets, or increased the risk of default by reducing its cost to the borrower. In either case the effect would be to increase the interest rate on non-corporate loans relative to corporate loans.

Rate of business growth, region, the size of the lending bank, the size of the market (rural versus urban) and the branching laws applicable in the state were related to the average rate charged. Loan rates were consistently higher in statewide branching states, but never more than 80 basis points. Small lenders provided consistently lower rates (perhaps because they make relatively more small loans for which rates were lower than for large loans), but never more than 130 basis points. Firms in rural areas consistently reported lower loan rates. These differences could have been due to a lower cost of funds because smaller banks historically have had a lower proportion of interest sensitive deposits compared to large banks.

Between 1980 and 1982 the rural-urban, small bank-large bank, and unit-statewide differentials narrowed substantially (Table 19). The continuing effect of deregulation on the liability side of commercial bank balance sheets contributed to the narrowing interest rate differentials. Penetration of money market mutual funds into rural markets induced smaller banks to offer jumbo (over $10,000) CD's at market rates to prevent the loss of their biggest depositors. The result was higher lender costs. Further, loans tied to the prime rate occur more frequently in large banks, metropolitan banks, and banks in statewide branching states. Small firms located in these areas will, on average, find their rates rising more rapidly in periods when the prime rate is rising, e.g. April 1980. In April 1982, interest rates had stabilized and most fixed rate loans adjusted (with a lag) to these higher rates, thus narrowing the bank structure and locational differences. With the dramatic decline in the prime rate during the third quarter of 1982, it should not be surprising, then, that (1) the average short-term rates on rural loans exceeded metropolitan loans; and (2) the average rate on loans made in unit banking states exceeded the average rate on loans made in statewide branching states (Table 20). Thus, the ostensible bank structure effect on contract rates in the 1980 survey may be attributable to differences in the proportion of prime rate loans.

Table 20

INTEREST RATES PAID ON SHORT-TERM LOANS
(12 Months or Less)

Average Rates Paid During Quarter	1981				1982		
	I	II	III	IV	I	II	III
Bank Market:							
Rural	18.2%	18.6%	17.6%	17.6%	17.4%	17.4%	16.0%
Suburban	19.1	19.6	18.0	18.0	17.7	17.5	15.7
Metropolitan	19.7	20.1	18.1	18.1	18.1	17.7	15.1
Branching Status:							
Statewide	19.7	19.8	18.2	18.2	18.1	17.8	15.6
Limited	18.4	19.2	17.6	17.6	17.5	17.3	15.5
Unit	19.0	19.1	17.8	17.8	17.6	17.5	15.8

Source: Quarterly Economic Report for Small Business (National Federation of Independent Business), various editions.

III. Credit Availability and Small Business

A. Ability to Obtain Credit

Most small businesses were able to arrange the desired financing. Over 50 percent reported all of their credit needs have been met, while less than 15 percent reported that some needs or major needs had not been met (Table 21). The remainder reported most needs fulfilled. Additionally, 83 percent in both surveys reported that 90 to 100 percent of the most recent initial loan request had been granted (Table 22).

Over 70 percent reported that originally requested loan terms were received (Table 23). Although the percentage fell by two

Table 21

CREDIT EXPERIENCE BY SELECTED VARIABLES

	Credit Needs Met:							
	All		Most		Some Not		Major Not	
	80	82^1	80	82^1	80	82^1	80	82^1
Years in Business:								
1-2	44%	37%	29%	25%	12%	16%	8%	11%
3-4	47	39	27	27	15	13	9	12
5-6	40	44	37	26	11	13	7	5
7-10	50	52	32	24	9	8	4	6
11-15	55	51	28	25	10	11	3	4
16-20	59	52	26	21	9	11	3	1
21 +	68	56	19	16	6	5	2	2
No Answer	67	67	5	11	19	0	0	0
Business Activity:								
Rapidly Growing (21+%)	54	48	27	24	8	11	7	5
Growing (6-20%)	58	54	28	21	8	7	3	4
Steady (0-5%)	62	49	23	21	8	8	3	5
Decline	38	48	29	20	18	13	10	7
Too New	53	40	18	29	10	11	12	12
No Answer	19	49	19	13	10	1	4	6
Collateral Required:								
Yes	47	49	31	25	12	12	5	6
No	66	53	20	16	6	6	3	3
Banks Used:								
1	59	53	25	20	8	8	4	5
2	49	47	31	23	11	10	5	5
3 or More	53	50	25	23	13	15	6	3
Active Solicitation:								
Yes	58	58	26	20	9	8	4	3
No	54	46	26	24	11	10	5	7
Bank Size: ($ Million)								
Less than 100	58	52	25	22	9	10	4	5
100-500	54	51	27	22	11	9	5	4
Greater than 500	52	49	29	21	9	8	5	7

Table 21 (cont.)

CREDIT EXPERIENCE BY SELECTED VARIABLES

	Credit Needs Met:							
	All		Most		Some Not		Major Not	
	80	82[1]	80	82[1]	80	82[1]	80	82[1]
Community Size:								
Rural	58	51	26	21	8	10	4	5
Small City	55	52	26	21	10	9	4	5
City	52	48	27	25	12	9	5	5
Metropolitan	51	50	30	18	11	7	4	7
State Branching Law[2]								
Statewide	52	44	28	24	11	9	5	7
Limited-One Bank	55	52	26	19	10	11	4	4
Multi Bank	61	54	23	20	8	9	4	4
Unit - One Bank	63	56	23	25	6	7	5	3
Multi Bank	55	56	29	20	8	8	4	4
All Firms	56	51	26	22	10	9	4	5

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[1] 1982 survey included a classification "does not borrow".

[2] Limited and unit branching categories are broken down by holding company classification.

points from 74 to 72 between 1980 and 1982, substantial majorities of operating firms did receive their requested loan sizes and loan terms even in the difficult period covered by the surveys. While most firms were satisfied with loan terms, satisfaction did fall between 1980 and 1982. The proportion reporting terms very satisfactory fell from 41 to 35 percent, while the proportion reporting terms not good or unsatisfactory rose from 16 to 20 percent. The interest rate on the loan was the most frequently mentioned reason for loan term dissatisfaction (Table 24). This percentage jumped from 43 percent in 1980 to 63 percent in 1982; at the same time, satisfaction with loan size and maturity fell from 10 percent to 6 percent.

This shift in reasons for dissatisfaction closely reflects the difference in credit market conditions between April, 1980, and April, 1982. In April, 1980, the Fed was rapidly contracting the money supply (-12.4% annualized change in M1 from the end of February to the end of April) and banks adjusted to this decline by shortening maturities or lowering the amounts offered. Between February and April, 1982, the seasonally adjusted money supply grew at a 7 percent annual rate. And, not suprisingly, problems with loan amounts fell. The increased proportion of firms reporting problems with the loan interest rate undoubtedly reflected the cumulative effect of an historically high debt service burden over the past three years.

Firms that did report credit availability problems (general satisfaction, percent granted, etc.) appeared to be riskier than

Table 22

CREDIT AVAILABILITY BY SELECTED VARIABLES

	Percent of Initial Loan Request Granted						Credit Availability Effect on Expansion Plans					
	90-100%		50-89%		under 50%		Yes		No		Don't Know	
	80	82	80	82	80	82	80	82	80	82	80	82
Years in Business:												
1-2	78%	75%	10%	6%	5%	11%	47%	46%	35%	37%	30%	15%
3-4	82	78	6	4	5	13	54	49	32	37	21	13
5-6	82	85	8	2	3	9	51	43	35	42	21	17
7-10	83	85	7	1	1	9	47	42	40	46	26	20
11-15	86	83	5	3	2	6	43	32	47	48	28	20
16-20	86	90	2	2	2	3	43	32	42	51	27	23
21 +	83	84	3	1	2	4	35	32	51	52	35	25
No Answer	90	61	0	0	0	11	43	17	38	56	33	22
Business Activity:												
Rapidly Growing (21%)	85	80	6	4	4	9	45	41	44	48	27	21
Growing (6-20%)	85	86	5	1	3	6	45	34	43	49	28	25
Steady (0-5%)	83	84	5	1	1	7	36	37	49	44	34	18
Decline	82	83	6	3	4	6	63	42	26	41	15	16
Too New	86	73	4	9	6	11	39	44	35	40	37	19
No Answer	56	73	3	1	3	9	22	37	47	39	44	19
Collateral **Required:**												
Yes	85	85	8	3	3	10	52	43	37	44	23	16
No	80	81	2	2	2	3	33	32	51	51	36	27
All Firms	83%	83%	5%	2%	3%	7%	44%	41%	43%	47%	7%	6%

Table 23

LOAN TERM SATISFACTION

	Percent of All Firms		Received Originally Requested Loan Terms						Satisfaction with Loan Terms							
			Yes		No		Terms Given		Very Satisfactory		Satisfactory		Not Too Good		Unsatisfactory	
	80	82	80	82	80	82	80	82	80	82	80	82	80	82	80	82
Years in Business:																
1-2	8%	6%	71%	66%	16%	15%	7%	15%	38%	32%	35%	35%	16%	23%	4%	8%
3-4	12	10	74	65	11	14	10	18	38	25	37	44	17	22	3	6
5-6	10	9	67	72	12	9	14	15	32	29	42	42	17	23	2	2
7-10	16	16	77	73	8	10	10	12	38	32	39	42	16	16	3	5
11-15	12	12	75	73	12	9	8	11	40	29	39	45	11	17	4	4
16-20	10	9	74	80	9	8	9	7	40	37	34	42	14	12	2	4
21 +	31	37	75	71	7	8	7	11	48	41	31	35	9	12	3	2
No Answer	1	1	67	56	14	0	9	17	38	33	29	17	14	22	9	6
Business Activity:																
Rapidly Growing (21%)	10	14	75	71	14	11	8	10	41	32	32	40	17	19	4	3
Growing (6-20%)	47	39	76	75	10	10	8	10	42	38	37	39	12	15	3	3
Steady (0-5%)	27	21	74	71	7	8	11	14	44	34	35	41	12	15	1	3
Decline	11	19	71	69	14	9	8	15	31	32	34	39	21	19	7	4
Too New	2	4	75	66	10	15	10	15	43	32	35	40	12	14	6	11
No Answer	3	3	49	66	6	4	6	12	26	33	25	30	8	15	3	7
Collateral Required:																
Yes	56	56	74	70	14	14	10	14	34	28	40	45	19	22	4	5
No	44	44	74	73	5	4	8	10	50	43	29	32	6	9	2	2
All Firms	100%	100%	74%	72%	10%	10%	9%	12%	41%	35%	36%	39%	13%	16%	3%	4%

Table 24

REASONS FOR LOAN TERM DISSATISFACTION
BY SELECTED VARIABLES

	Interest Rate		Amount		Maturity		Collateral		Comp. Balances		Treatment		Time		Under-stand		Other	
	80	82	80	82	80	82	80	82	80	82	80	82	80	82	80	82	80	82
Years in Business:																		
1-2	42%	49%	11%	10%	11%	6%	10%	14%	0%	2%	6%	7%	7%	6%	7%	6%	6%	0%
3-4	45	54	13	9	10	5	14	12	1	4	4	5	7	5	3	5	3	1
5-6	39	60	13	4	11	7	14	14	1	1	5	4	6	6	9	5	1	0
7-10	45	63	10	7	10	3	18	12	1	3	5	4	7	3	3	3	2	2
11-15	54	69	11	5	6	6	11	10	2	0	4	3	4	2	5	5	4	0
16-20	63	76	6	0	6	5	12	8	2	4	2	1	3	5	3	1	2	0
21 +	53	67	8	4	11	9	11	9	2	3	4	2	4	3	6	2	2	1
No Answer	64	78	0	11	27	0	9	0	0	0	0	0	0	0	0	11	0	0
Business Activity																		
Rapidly Growing (21%)	42	64	11	5	9	6	14	10	1	3	2	3	8	4	8	4	5	1
Growing (6-20%)	49	62	9	6	10	4	12	12	1	4	5	3	5	3	6	5	2	1
Steady (0-5%)	50	70	10	3	11	7	12	10	1	2	4	3	6	2	4	2	2	1
Decline	51	63	12	6	9	7	14	12	2	1	3	5	4	3	3	2	2	1
Too New	48	62	8	7	16	7	4	10	0	1	4	2	4	5	8	5	8	1
No Answer	43	57	7	5	7	11	21	8	0	0	7	5	7	8	4	6	4	0
Collateral Required:																		
Yes	44	57	11	6	11	6	16	14	1	3	4	4	6	4	5	4	2	1
No	67	79	9	4	6	6	2	1	0	0	5	3	3	2	6	2	3	2
All Firms	49%	63%	10%	6%	10%	6%	13%	11%	1%	2%	4%	3%	5%	4%	5%	4%	3%	1%

average. Firms in business under 4 years or too new to assess their growth more frequently reported major credit needs not met, less than 100 percent of their initial loan request granted, not receiving their originally requested loan terms, dissatisfaction with loan terms, and reduction in expansion plans due to credit availability. Firms that reported declining sales or rapid growth and those reporting secured loans also more frequently reported less favorable credit experience than did others. Risk also appeared to be inversely related to those firms reporting the interest rate as a reason for dissatisfaction.

The effect of bank structure characteristics upon credit availability was mixed. Only the distributions for the general credit experience variable are presented in Table 21, because all of the availability questions resulted in the same general pattern of responses. Borrowers from smaller banks and banks in rural areas more frequently reported all credit needs met, although these differences narrowed in 1982. No clear pattern existed between firms reporting credit needs not met and bank size or bank market. A stronger relationship appeared between credit availability and solicitation by a bank for its business within the last five years. Firms that were solicited more frequently reported all credit needs met. The degree of branching also affected credit availability, as firms residing in states with statewide branching less frequently reported all credit needs met.

B. Loan Rejections

Over 85 percent of the firms that reported a loan attempt at a commercial bank had their most recent request accepted (Table 25). The rejection rate was 13 percent in 1980 and 11 percent in 1982. "Low equity" or "too much debt" proved common reasons for rejection, the latter doubling in frequency between 1980 and 1982. This increase mirrored the deteriorating financial condition of business in general caused by low sales and the high cost of financing working capital. "Tight money," on the other hand, fell from 27 percent to 9 percent as a reason for rejection. If credit availability had been a problem in 1980, due to controls imposed on bank asset growth as well as the rapid contraction in the money supply, it was not in 1982.

Newer firms (under 4 years in business) more frequently reported a loan rejection, reflecting the higher default risk associated with newer firms (Table 26). Declining firms most frequently reported a rejection in 1980. Rapidly growing firms were most frequently rejected in 1982, but at about the same rate as in 1980. Rejection rates decreased as borrowing frequency increased, presumably because regular borrowers are better established with their lending institutions.

Table 25

REASON FOR LOAN REFUSAL

Reason	April 1980	April 1982
Too New	13%	16%
Too Much Debt	9	18
Lender Had No Money	27	9
Use Not Wise	8	4
Couldn't Repay	1	3
Low Equity	10	14
Poor Pay History	1	3
Weak Financial Statement	11	11
No Idea (Why Loan Refused)	10	12
No Answer	10	10
Total	100%	100%
Total Attempts[1]	2012	1849
Total Rejected	254	193
Total Accepted	1709	1583
Rejection Rate	.13	.11
Acceptance Rate	.85	.86

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[1] Included those whose decision on the loan request is pending.

Firms that used only one bank least frequently reported rejections. Those that applied to a bank other than their principal bank more frequently reported rejections. Whether that implies a rejection at the firm's principal bank first is not known. Loan applicants at branch offices also more frequently reported rejections. This pattern is consistent with firms in statewide branching states less frequently reporting acceptance of the latest loan request.

Table 26

CHARACTERISTICS OF ACCEPTED AND REJECTED FIRMS

			Last Loan Attempt					
	Total		Accepted		Rejected		Don't Know	
Characteristics	1980	1982	1980	1982	1980	1982	1980	1982
Years in Business:								
1-2	8%	6%	76%	72%	21%	22%	3%	7%
3-4	12	10	74	75	20	21	5	4
5-6	10	9	79	86	18	12	3	2
7-10	16	16	85	83	13	12	2	5
11-15	13	12	87	89	12	10	1	1
16-20	10	9	89	84	9	12	2	4
21+	30	36	92	91	7	6	2	4
No Answer	1	1	89	100	6	*	6	*
Business Activity:								
Rapidly Growing(21%+)	10	15	85	83	14	15	1	2
Growing(6-20%)	48	39	86	90	11	7	3	3
Steady(0-6%)	26	20	88	85	10	10	2	5
Declining	11	20	79	85	19	12	2	3
Too New	2	4	78	66	16	22	5	12
No Answer	2	3	61	81	29	15	9	4
Number of Times Borrowed in Year:								
Once	26	25	84	84	13	13	3	4
Twice	16	15	86	87	12	10	3	3
Three or more	24	22	88	92	10	6	2	2
No Answer	33	38	83	83	15	12	31	5
Loan Source:[1]								
Principal Bank-Hdqtr	87	58	86	90	12	7	2	3
Principal Bank-Bran		28		81		15		4
Other Bank	6	6	71	64	26	17	3	9
Use One Bank Only	3	4	90	88	3	5	7	7
No Answer	4	4	81	90	13	10	6	*
State Branching Law:								
Statewide	34	35	81	81	16	15	3	4
Limited-MBH[2]	25	27	87	86	11	10	2	4
Limited-NMBH[3]	10	10	90	88	8	9	2	3
Unit-NMBH[3]	10	8	92	92	6	6	2	2
Unit-MBH[2]	17	20	84	90	14	7	2	3
No Answer	3	*	81	71	16	14	3	14
Total	100%	100%	85%	86%	13%	11%	2%	4%

---

[1] The 1980 Survey did not separate the principal bank category into headquarters versus branch.

[2] Multi-bank holding companies permitted

[3] No multibank holding companies permitted

* Less than 0.5 percent

IV. Bank Competition for Small Firm Business

Small business generally saw competition increase in their local banking markets between the survey dates. The proportion of firms reporting that a bank actively contacted them for business within the last five years rose from 37 to 40 percent (Table 27). Furthermore, the proportion of firms noticing more bank competition for their business compared to five years ago rose from 20 to 27 percent (Table 28). This increased interest in small firm business may be for several reasons. High interest rates binding against usury ceilings in some states, as well as high mortgage rates,

Table 27

ACTUAL BANK SOLICITATION WITHIN LAST FIVE YEARS
BY SELECTED VARIABLES

	1980		1982	
	Percent of all Firms	Percent Solicited	Percent of all Firms	Percent Solicited
Number of Banks in Community:				
1	8%	22%	8%	20%
2-3	28	30	26	34
4-5	24	39	25	41
6-10	18	45	20	48
11 or more	19	49	18	49
Community Size:				
Rural	40	29	41	30
Small City	30	43	30	42
City	19	46	20	51
Metropolitan	8	47	8	55
State Branching Law:				
Statewide	34	40	37	41
Limited-MBH[1]	25	36	26	41
Limited-NMBH[2]	11	30	10	37
Unit-NMBH[2]	10	35	8	34
Unit-MBH[1]	17	40	19	40
All Firms	100%	37%	100%	40%

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[1] Multi-bank holding companies permitted.
[2] No multi-bank holding companies permitted.
* Less than 0.5 percent.

Table 28

NOTICED A CHANGE IN BANK COMPETITION BY SELECTED VARIABLES

			Change in Competition							
	All Firms		Much More		More		Much Less		Less	
	1980	1982	1980	1982	1980	1982	1980	1982	1980	1982
Number of Banks in the Community:										
1	8%	8%	6%	3%	8%	9%	4%	6%	2%	0%
2-3	28	26	6	8	12	15	6	6	3	3
4-5	24	25	6	8	16	19	7	7	2	3
6-10	18	20	9	14	12	18	8	7	2	3
11 or more	19	18	8	14	13	20	10	5	3	2
Community Size:										
Rural	40	41	7	7	10	14	6	5	3	2
Small City	30	30	8	10	16	19	7	7	2	2
City	19	20	7	11	12	20	11	7	1	3
Metropolitan	8	8	8	22	16	15	6	7	2	2
State Branching Law:										
Statewide	34	37	8	11	12	18	8	6	1	3
Limited-MBH[1]	25	26	7	12	14	14	7	4	3	2
Limited-NMBH[2]	11	10	7	8	10	18	7	9	1	3
Unit-NMBH[2]	10	8	8	6	12	18	5	6	1	1
Unit-MBH[1]	17	19	6	9	13	16	6	7	4	3
All Firms	100%	100%	7%	10%	13%	17%	2%	3%	7%	6%

---

[1] Multi-bank holding companies permitted.

[2] No multi-bank holding companies permitted.

restricted consumer credit and mortgage lending. Furthermore, the extreme competition for large firm business, e.g. from loan production offices, may have eroded the profitability of these loans. Both situations would have stimulated an interest in the small business loans as more profitable lending activity.

Changes in bank competition did not occur evenly. Small firms located in markets with four or more banks more frequently reported an active contact as well as increased competition among banks for their business. In 1980 and 1982, less than 30 percent of the firms in markets with three banks or less reported an active contact, while almost 50 percent reported a contact in markets with 11 or more banks. The frequency of active contacts and perceived increase in competition rose with the size of the market. Only 29 percent of the firms in rural markets reported a contact, versus 47 percent in metropolitan markets in 1980 (30 versus 55 percent in 1982); 17 percent of the rural firms reported a change in competition, versus 24 percent of the metropolitan firms in 1980 (21 versus 37 percent in 1982).

Differences in branching/holding company restrictions also affected the chance of a small business noticing a change in competition in its banking market. In 1980 only 30 percent of the firms located in limited branching states (where multi-bank holding companies are not permitted) reported an active contact while 40 percent of the firms in statewide branching states or in unit banking states with multi-bank holding companies were contacted. By 1982, only firms located in states prohibiting multi-bank holding companies less frequently reported an active bank contact. The frequency of perceived change in bank competition, however, showed no strong relationship to branching/holding company status in either 1980 and 1982.

V. Small Business and Its Banking Relationships

Each firm was asked to characterize its desired banking relationship and to rate the performance of its principal bank in terms of the ten dimensions listed on Table 29. All of the characteristics, with the exception of "Offers the Cheapest Money" represent non-price dimensions of a banking relationship. Small businesses rated the importance of these ten characteristics in their desired banking relationship from 1 (very important) to 4 (not important). Next they ranked their major bank's performance on these same characteristics from 1 (good) to 4 (not good). The 1982 list of characteristics differed slightly from the 1980 list: "Easy Access to Loan Officer" was inserted in place of "Knows Your Financial Needs."

A. Rankings of Desired Characteristics

The interest rate charged on a loan was not the most important aspect in a small business-banking relationship, despite record high nominal and real rates at the time of the surveys (Table 29). "Knows You and Your Business" was most frequently ranked very important (67 percent in both surveys), followed by "Reliable Source of Credit" (55 percent). "Offers the Cheapest Money," the third most frequently noted characteristic in the desired banking relationship, was ranked very important by 50 percent of the firms. Those characteristics least frequently reported as very important to

Table 29

DESIRED CHARACTERISTICS IN A BANKING RELATIONSHIP AND PRINCIPAL BANK PERFORMANCE

	Respondent Evaluation									
	Very Import/ Good		Important/ Above Average		Not Very Important/ Below Average		Not Import/ Not Good		No Answer	
Characteristics	80	82	80	82	80	82	80	82	80	82
Knows Your Business										
Desired Characteristics	67%	68%	21%	22%	3%	3%	1%	2%	8%	6%
Bank Peformance	46	46	28	29	12	13	5	5	9	7
Provides Helpful Business Suggestions										
Desired	24	21	32	33	20	24	11	13	12	9
Bank	20	18	25	27	27	28	15	17	13	11
Offers the Cheapest Money										
Desired	17	50	28	30	9	8	4	3	12	9
Bank	26	22	33	34	15	21	11	12	14	12
One Person Handles Credit Needs										
Desired	40	40	35	37	11	11	4	4	11	8
Bank	44	44	30	32	8	8	6	5	12	10
Convenient Location										
Desired	39	30	37	39	11	20	3	6	10	7
Bank	52	55	28	27	6	7	3	2	11	9
Easy Access to Loan Officer										
Desired	na	42	na	41	na	6	na	3	na	8
Bank	na	50	na	32	na	5	na	4	na	10
Reliable Source of Credit										
Desired	54	55	30	31	3	4	2	2	11	8
Bank	46	48	29	28	8	9	5	5	12	10
Knows Your Industry										
Desired	29	27	37	32	19	23	7	9	13	10
Bank	24	21	27	29	22	24	13	15	15	12

Table 29 (cont.)

DESIRED CHARACTERISTICS IN A BANKING RELATIONSHIP
AND PRINCIPAL BANK PERFORMANCE

	Respondent Evaluation									
	Very Import/ Good		Important/ Above Average		Not Very Important/ Below Average		Not Import/ Not Good		No Answer	
Characteristics	80	82	80	82	80	82	80	82	80	82
Ideas to Improve Bank Service										
Desired	19	17	33	34	23	26	11	12	14	11
Bank	14	15	21	23	27	26	22	24	15	13
Knows Your Financial Needs										
Desired	34	na	38	na	10	na	5	na	13	na
Bank	26	na	31	na	18	na	11	na	14	na
Wide Range of Business Services										
Desired	34	32	38	42	12	15	4	3	12	8
Bank	42	47	33	32	8	8	5	3	12	10

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na not asked.

the desired banking relationship were "Providing Helpful Business Suggestions" and "Comes to You with Ideas for Improving Bank Services." These rankings suggest that the "consulting" aspect of the banking relationship is viewed as less important than continuity and availability of credit.

B. Ratings of Performance

Rating of bank performance differed markedly from the ratings of desired characteristics in a banking relationship. Banks most frequently received good ratings on accessibility ("Convenient Location" and "Easy Access to a Loan Officer"). "Reliable Source of Credit," "One Person Handles Credit Needs," "Knows You and Your Business," and "Offers a Wide Range of Banking Services" also received good performance ratings, although significantly lower than accessibility.[4] The two characteristics least frequently rated as very important to the banking relationship ("Provides Helpful Business Suggestions" and "Offers Ideas to Improve Bank Service") were also least frequently rated "good" on performance.

Performance was also analyzed by community size (urban versus rural locations) and by branching restrictions (statewide versus unit) to investigate the claim that more liberalized branching/holding company restrictions result in better service to the banking customer.[5] Many independent bankers (especially those in rural areas) feel threatened by further deregulation because of their perceived inability to compete with larger banks that may enter their market with new branches or purchases of existing banks. Bankers in unit banking states may also see a potential threat to their markets from large banks in statewide branching states. While these data do not address all the issues involved in the debate over the effect of further bank deregulation on the quality of bank service offerings, they do provide some insight into which market structures currently provide small businesses with better performance. The data are presented in Tables 30 and 31 in two ways. The first uses the "good" performance ratings, while the second uses the "good" plus "above average" ratings.

In both surveys, rural banks more frequently received good performance ratings (relative to banks in urban areas) on almost everyone of the characteristics.[6] This superior performance was only statistically significant for "Knows You and Your Business" and "Reliable Source of Credit," using the "good" ratings. For the good plus above average ratings, "One Person Handles Credit Needs," "Knows My Industry" and "Knows My Financial Needs" were significantly higher for rural banks. The persistence of the urban-rural differences in performance is consistent with the generally accepted notion that rural banks have closer relationships with their customers. These urban-rural peformance differentials were not attributable to differences in desired characteristics in the banking relationship or individual characteristics of the respondents to the survey.

In the 1980 and 1982 survey, firms located in unit branching states rated their bank's performance significantly better than firms in statewide branching states (using the good ratings) for "Knows You and Your Business," "One Person Handles Credit Needs" and "Reliable Source of Credit." The good plus above average ratings provided mixed results. In 1980, banks in unit branching states were rated significantly better performers for all of the characteristics except "One Person Handles Credit Needs," "Convenient Location" and "Offers a Wide Range of Banking Services." By 1982, however, unit banks performed significantly

Table 30

MAJOR BANK PERFORMANCE BY COMMUNITY SIZE

	Community Size							
	Rural[1]		Small City[2]		City[3]		Metropolitan[4]	
Characteristics	80	82	80	82	80	82	80	82
Knows You and Your Business								
Good	51	41	49	45	38	37	41	44
Good + Above Average	77	79	76	74	70	69	73	74
Provides Helpful Business Suggestions								
Good	23	20	21	17	16	15	17	17
Good + Above Average	48	45	45	45	38	42	46	45
Offers the "Cheapest Money"								
Good	29	23	27	22	22	21	23	19
Good + Above Average	60	54	62	57	57	58	62	56
One Person Handles Credit Needs								
Good	45	46	44	44	42	42	47	45
Good + Above Average	76	79	76	75	71	73	76	77
Convenient Location								
Good	56	59	51	54	51	54	49	46
Good + Above Average	81	86	82	84	79	80	79	74
Easy Access to Loan Officer								
Good	na	52	na	48	na	49	na	52
Good + Above Average	na	83	na	81	na	81	na	85
Reliable Source of Credit								
Good	51	52	46	47	42	45	43	44
Good + Above Average	77	78	77	76	74	74	76	77
Knows Your Industry								
Good	28	24	23	20	19	17	17	17
Good + Above Average	55	53	52	48	44	46	49	52
Ideas to Improve Service								
Good	15	16	16	13	10	13	13	15
Good + Above Average	37	37	36	36	32	40	35	38

Table 30 (cont.)

MAJOR BANK PERFORMANCE BY COMMUNITY SIZE

Characteristics	Community Size							
	Rural[1]		Small City[2]		City[3]		Metropolitan[4]	
	80	82	80	82	80	82	80	82
Knows Your Financial Needs								
Good	29	na	26	na	21	na	25	na
Good + Above Average	61	na	58	na	52	na	57	na
Offers Wide Range of Banking Services								
Good	42	50	45	46	43	46	42	46
Good + Above Average	74	79	78	83	78	79	79	77

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[1] Up to 15,000 population
[2] 15,000 to 100,000 population
[3] 100,000 to 1,000,000 population
[4] Over 1,000,000 population
na not asked.

better on only four characteristics ("Offers Cheapest Money," "One Person Handles Credit Needs," "Easy Access to Loan Officer" and "Reliable Source of Credit").

One explanation for the relative improvement in the performance ratings of banks in statewide branching states is related to the average interest rate differential on loans made in statewide and unit branching states. In the 1980 survey, firms with lower contract rates rated bank performance higher. In that survey firms in statewide branching states paid higher contract rates of interest than those firms located in unit branching states contributing to the poorer performance ratings. The decline of the unit-statewide interest rate differential in 1982, not surprisingly, was accompanied by a relative improvement in statewide bank performance ratings. Still, the statewide-unit performance differences persisted across both surveys and again were not attributable to differences in the desired banking relationship or the characteristics of the respondents. The data in Table 31 thus suggest that more liberalized branching laws are not likely to bring "improved" service to small business borrowers; in fact, they imply just the opposite.

Table 31

MAJOR BANK PERFORMANCE BY BRANCHING LAWS

	Branching Laws					
	Unit[1]		Limited[2]		Statewide	
Characteristics	80	82	80	82	80	82
Knows You and Your Business						
Good	50%	49%	47%	47%	42%	42%
Good + Above Average	80	77	74	74	70	73
Provides Helpful Business Suggestions						
Good	24	19	20	18	17	16
Good + Above Average	49	47	45	43	40	43
Offers the "Cheapest Money"						
Good	28	25	25	23	24	18
Good + Above Average	64	61	61	56	54	52
One Person Handles Credit Needs						
Good	48	50	43	42	41	42
Good + Above Average	72	80	73	76	68	73
Convenient Location						
Good	53	54	54	57	51	54
Good + Above Average	81	83	81	84	78	81
Easy Access to Loan Officer						
Good	na	52	na	49	na	49
Good + Above Average	na	85	na	81	na	79
Reliable Source of Credit						
Good	50	53	47	49	42	44
Good + Above Average	80	81	76	76	71	72
Knows Your Industry						
Good	26	24	24	20	21	19
Good + Above Average	57	53	51	49	47	48
Ideas to Improve Service						
Good	16	15	13	16	13	13
Good + Above Average	40	39	35	36	32	37

Table 31 (cont.)

MAJOR BANK PERFORMANCE BY BRANCHING LAWS

Characteristics	Branching Laws					
	Unit [1]		Limited[2]		Statewide	
	80	82	80	82	80	82
Knows Your Financial Needs						
Good	29	na	26	na	23	na
Good + Above Average	66	na	56	na	51	na
Offers Wide Range of Banking Services						
Good	43	49	44	47	41	46
Good + Above Average	78	80	75	79	74	79

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[1] Includes both limited and statewide holding companies.
na not asked.

C. Performance Relative to Desired Ratings

The data in Table 32 provide direct comparisons of what is viewed as important in banking relationships and how major banks performed on these characteristics. A more interesting criterion for performance evaluation is to compare the actual ratings to the desired ratings to obtain a measure of relative performance. By subtracting the desired rating percentage from the actual performance percentage, this relative performance measure can be interpreted as follows: if the difference is less than zero, bank performance falls short of what small business desires; if greater than zero, performance exceeds what was desired. These data, presented in Table 32, are presented like the data in Tables 30 and 31. The first column uses the best ratings for both desired characteristics and performance. In the second column, all of the favorable ratings are used, i.e. very important plus important for desired characteristics and good plus above average for performance.

The data in Table 29 for all respondents show that banks performed best relative to the desired (using the best ratings) on "One Person Handles Credit Needs," "Convenient Location," "Access to Loan Officer," and "Offers a Wide Range of Banking Services." Banks did worst on "Knows You and Your Business," "Offers the Cheapest

Table 32

DESIRED-ACTUAL PERFORMANCE DIFFERENCES

Characteristics	Very Important/ Good		Very Important & Important/Good & Above Average	
	80	82	80	82
Knows You and Your Business	-21[1]	-22	-14	-15
Provides Helpful Business Suggestions	-4	-3	-11	-9
Offers the Cheapest Money	-21	-18	-16	-24
One Person Handles Credit Needs	4	4	-1	-1
Convenient Location	13	25	4	13
Easy Access to Loan Officer	na	8	na	-1
Reliable Source of Credit	-8	-7	-9	-10
Knows Your Industry	-5	-6	-10	-9
Ideas to Improve Service	-5	-2	-17	-13
Knows Your Financial Needs	-8	na	-15	na
Wide Range of Banking Services	8	15	0	0

---

[1] In percentage points.
na not asked.

Money," and "Reliable Source of Credit," and all of these differences were significant. With the exception of "Provides Helpful Business Suggestions" and "Comes to You with Ideas to Improve Bank Service" in 1982, all of the performance proportions differed significantly from the desired proportions. Similar patterns were observed when the sample was broken down by community size and branching laws.

The average ratings gave slightly different results. Banks performed significantly better than desired only on "Convenient Location," with no significant difference on "Comes to You With Ideas to Improve Bank Service," "One Person Handles Credit Needs" or "Easy Access to Loan Officer." Thus the differences between those rating a characteristic as "important" and rating bank performance as "above average" were of sufficient magnitude to reduce the relative satisfaction with bank performance on these characteristics.

The relatively poor performance of banks on offering the cheapest money available is not surprising considering the high interest rates at the time of the surveys. The good performance of banks having one person handle credit needs but poor performance on knowing the firm's business is puzzling. Perhaps the lending officer has multi-product responsibilities (e.g. small business, consumer credit), and the small business borrower feels that not enough time is devoted to his or her needs. Or the small business sees a frequent turnover of lending offices and is frustrated by the continual "re-learning" process required by the new officer. Banks have performed well in providing non-personal dimensions of the desired banking relationship, e.g. location and service offerings, even though most small business borrowers did not rank these characteristics as most important in their desired banking relationship.

VI. The Economic Performance of Small Business Borrowers and Non-Borrowers

Small business economic performance deteriorated in late 1979 and early 1980 as both high interest rates and a weak economy reduced employment, capital expenditures and earnings. Comparing the 1980-1982 period with 1976-1979 (See Table 33), the average net percentage of firms reporting earnings increases fell 16 percentage points; the net percentage reporting dollar increase in sales volume fell 18 percentage points; and net reported employment gains fell 10

Table 33

BORROWER/NON-BORROWER PERFORMANCE[1]

	All Firms	Borrower	Non-Borrower	Difference
Net Earnings Change During Last 3 mos. (% higher minus % lower):				
April 1976 to January 1980	- 16%	- 17%	- 15%	- 2%
April 1980 to April 1982	- 32	- 38	- 27	- 11
Sales Volume Change During Last 3 mos. (% higher minus % lower):				
April 1976 to January 1980	16	17	16	1
April 1980 to April 1982	- 2	- 5	- 2	- 3
Index of Reported Price Increases:[2]				
April 1976 to January 1980	2.91	3.16	2.62	0.54
April 1980 to April 1982	2.51	2.60	2.46	0.14
Actual Capital Expenditures During Last 3 mos. (% yes minus % no):				
April 1976 to January 1980	25	35	14	21
April 1980 to April 1982	10	15	7	8
Employee Change During Last 3 mos. (% increase minus % decrease):				
April 1976 to January 1980	5	5	3	2
April 1980 to April 1982	- 5	- 8	- 4	- 4
Current Job Openings (% yes minus % no):				
April 1976 to January 1980	- 52	- 44	- 59	15
April 1980 to April 1982	- 70	- 68	- 72	4

---

[1] Borrowers include those firms who reported borrowing regularly, i.e. at least once every three months.

[2] The Index of Reported Price Increases is a weighted average based on the responses to the survey question as to how much higher selling prices are now compared to three months ago. The 2.91 for all firms means that the average quarterly price increase was 2.91 percent.

percentage points. Borrowers and non-borrowers, however, did not share this poor performance equally. Borrowing firms[7] suffered a greater decline in earnings, capital expenditures, and employment than did non-borrowing firms. This phenomenon was produced by a massive shift in the nature of borrowing--a shift from investment-growth borrowing to cash flow-survival borrowing.

The net percent reporting higher net earnings varied little between borrowers and non-borrowers from 1976 through 1979, with non-borrowers averaging two percentage points higher than borrowers. After early 1980, however, non-borrowers reported net earnings changes averaging 11 percentage points higher than borrowers. Borrowers could have improved their net earnings relative to non-borrowers through increased sales or higher prices, as in the pre-1980 period, but sluggish demand closed both avenues. The percent of borrowers reporting a net increase in the dollar volume of sales from the previous quarter was slightly above non-borrowers from 1976 through 1980, but fell below non-borrowers from 1980 to the present. This was due in part to the fact that construction and manufacturing, both heavily dependent on borrowing, were severely affected by the recession. Although borrowers generally reported higher price increases than non-borrowers throughout the 1970s, this difference narrowed after 1980 to the point where non-borrower price increases were greater than borrower increases in 1982.8/ Faced with high inventory carrying costs and slow sales, borrowers have been forced to forego price increases in order to sell inventory and reduce a major fixed cost--interest expense.

Continued high interest rates also caused borrowers to reduce their capital expenditures. From April, 1979, through July, 1980, the net percent of borrowers reporting capital expenditures exceeded that of non-borrowers by 20 percentage points. After 1980, the average borrower/non-borrower difference fell to seven percentage points.

Employment gains by borrowers also fell relative to non-borrowers. Until mid-1979, borrowing small businesses consistently reported greater net employment gains. The net percentage adding employees averaged 5 percent for borrowers and 3 percent for non-borrowers. Since mid-1979, both borrowers and non-borrowers reported net losses in employment, but non-borrower losses have been less than those of borrowers. Borrowers averaged a net decrease of 8 percentage points, versus 4 percentage points for non-borrowers. Only during the second quarter of the brief expansion of 1981 did net employment gains from borrowers exceed those of non-borrowers. Because employment is a major variable cost under the control of the small firm, larger cuts by firms burdened with heavy interest obligations were not surprising. Firms even anecdotically reported terminating employees to raise cash in order to meet interest obligations.

C. Summary and Conclusions

Small business historically has relied heavily on the entrepreneurs's capital for its initial financing. New firms are risky and usually very small in scale. This high risk has limited the role of institutional investors, such as banks, in financing small business starts, although the importance of bank loans has grown over time. Once the firm is established, bank lending provided most of the financing for established firms. The role of government financing was inconsequential in comparison. Lenders such as credit unions, savings and loan companies and other savings institutions played minor roles in the financing of small business in the past. Their roles may increase in importance because of the new lending powers granted to these institutions by the Depository Institutions Deregulation and Monetary Control Act of 1980. The additional lending that these other depository institutions provide to small business most likely will be limited until these institutions gain expertise in the business loan market. Thus for the near future, banks can be expected to continue serving as the major source of capital to the small business community.

Almost all firms borrow money at some time during their existence. Over half borrow at least once a year, primarily from a bank. Small businesses on average are quite satisfied with their relationship with the banking community. More than half indicated that their credit needs were satisfactorily met, while at the other extreme, only 15% indicated that some needs or major needs were not met. This result is surprising for 1980 and 1982, periods of great turmoil and uncertainty in the capital markets. Over 80% of all firms reported than 90%-100% of their credit needs were met, while less than 10% reported getting less than half of their original loan request. In many instances, banks may have provided financial advice to applicant firms to assist them in determining that less money could be borrowed, helping these small firms to keep interest cost and leverage down. Over 70% reported that their originally requested loan terms were met, and less than 20% of the borrowing firms characterized the terms received as "not good" or "unsatisfactory." If this characterizes the experience of small firms during such difficult times, their collective borrowing experiences during "normal" periods are probably quite satisfactory.

The frequency of loan rejections, loan size reductions, and less than satisfactory terms suggests that there is at least the potential for improvement in the service provided by the banking community to small business. This does not mean some firms should not have difficulty getting credit, or that firms should not be refused, or granted less in volume or terms than they might like. A competitive market must produce these kinds of decisions. Rather, the issue is whether or not observed levels of difficulties are the lowest that could be produced in the market. Most economists believe that these problems will be minimized (in the absence of any subsidies) by a competitive financial market. But just what constitutes a competitive market is less clear. An increased number of competitors is generally thought to induce a greater degree of competition. This conclusion has led many observers, supported by some empirical research,[9] to argue that statewide bank branching laws are the most favorable to the development of competition and to the exploitation of any scale economies that might exist. However, banks operating under unit or limited branching laws can still be quite competitive in a local, geographically compact financial market. And statewide branching may lead to increased concentration through holding company acquisitions rather than increased numbers of competitors.

This study provided no evidence that firms were better served in statewide branching states than under any other form of branching regulation. The data suggested that, by 1982, small businesses fared no better under statewide branching regulations than they did under unit banking regulations. Active solicitation of firm business by banks increased with the number of banks in the community, which the competitive model based on numbers of firms would predict. The policy question, then, may be which form of branching rule produces the largest number of independent competitors. A good case can be made for unit banking. Statewide holding companies seem more likely to acquire independent existing banks than to open new branches. Perhaps more liberalized branching laws are justified by the value of scale economies that can be exploited by larger banks, ultimately resulting in cheaper bank services, but the data in this study do not provide evidence strongly supporting this contention.

The notion that small firms always pay more than the prime rate for their credit is also clearly incorrect. Although about one-third of all short-term loans are tied to the prime rate, most are at or below prime or no more than one point above. Many loans are obtained at rates substantially below the prime rate prevailing at the time the loan was made. The prime rate has become a very political rate in recent years. Banks have also been reluctant to change the rate in response to the volatility in the financial markets. Consequently, many loans have been made at "less than prime," but certainly at competitive rates. The argument that small firms are "riskier" and must therefore pay more for their credit may be true on average (since many small firms are very new), but cannot be true for many well established small companies that are well known and respected in their local financial markets. Thus one would expect, as this study found, that the variation in rates paid is very large compared to what one would expect to find among larger, well established firms. Even for these largest firms, the market exacts significant risk premiums for borrowing when the firm is not on a sound financial footing.

Ratings of major bank performance on these desired characteristics showed marked differences from desired ratings. Banks were rated highest in providing accessability (locational convenience and access to a loan officer), followed by reliability as a source of credit, one person handling credit, knowledge of the business, and a wide range of service offerings. Comparing the actual ratings to the desired ratings for each characteristic, banks did best in offering locational convenience and a wide range of service offerings. In the opinion of small business, banks did best in providing the non-personal characteristics desired in a banking relationship, but have room for improvement on the dimensions involving personal contact.

With an increasing number of the larger firms in this economy turning directly to the capital markets to arrange their own financing, the small business market will likely grow in importance to the banking community. The smaller firms in the economy experience, on average, the most rapid growth. In an environment where survival borrowing does not dominate credit market transactions, the small business sector may generate a large share of bank lending business. With new competition from lenders previously excluded from participation in the small business loan market, the numbers of institutions competing for the small firm's business should increase, improving the service rendered to them by the financial community.

FOOTNOTES

1/ Legler, John B. and Frank Hoy, Building a Comprehensive Data Base on the Role of Small Business in the U.S. Economy, Heller Institute for Small Business Policy Papers, 1982.

2/ See A. S. McCall, "The Impact of Bank Structure on Bank Service to Local Communities," Journal of Bank Research 11 (Summer 1980): 101-109, for a review of these studies.

3/ How Small Businesses Begin (November 1979); National Federation of Independent Business.

4/ Significance is used here in a statistical sense. Because the surveys reflect responses from only a small sample of the small business population, the "true" population response may differ from those reported in the tables presented in this paper. This deviation of the sample proportions from the true proportion is referred to as "sampling variability." For example, it can be shown that for "Reliable Source of Credit" in Table 1, the true population proportion for very important ratings will be included in the interval 55%, plus or minus 2%, 95 percent of the time; likewise, 50%, plus or minus 2%, includes the true proportion for "Offers the Cheapest Money" 95 percent of the time. These proportions significantly differ because these intervals do not overlap. If the proportion for very important ratings for "Offers the Cheapest Money" was 53 percent, then it would not differ significantly from "Reliable Source of Credit." Also, the fewer the observations for any given rating category, the wider the interval around the sample proportion.

5/ See Footnote 2 for a reference to this literature.

6/ With so few observations available for the "metropolitan" category (198 in 1980 and 180 in 1982), the sample proportions are subject to a great degree of sampling variability (i.e., wide confidence intervals). In most cases the "metropolitan" proportion is not significantly different from the "city" proportion.

7/ Borrowers are firms reporting that they borrow regularly, i.e. at least once every three months. Non-borrowers could thus include some infrequent borrowers.

8/ The index of reported price increases for January and April 1982 was:

	January	April
Borrowers	1.59	1.30
Non-Borrowers	1.64	1.55

9/ See Footnote 2.

The **Chairman.** Let me say that your studies confirm what I have felt without quantifying for a long, long time. Before this committee, I don't know how many times I've made the statement that I represented a relatively small State with almost entirely small institutions. Our largest financial institution is very small compared to the giants around the country. And that the level of service provided is generally better and more personal by those small institutions. I don't think there's any doubt about it. So your statistics do not surprise me.

I know the situations in the small towns of Utah where they go in and they don't fill out all that credit reference. They just know that Farmer Jones' father paid their bills back for their loans and his grandfather did and they know that they will pay them back so they get the loan.

So I don't dispute that. But in your unwillingness to support interstate banking, the question comes to mind, does that really destroy it? A lot of people think it does. I'm sure you were here earlier and heard me talk about Mr. Wriston's testimony and his experience in upstate New York and also in California. Bank America doesn't need to leave California. They're quite large enough within the State. First Interstate Bank took over an existing old line bank in Salt Lake City, Walker Bank & Trust, and this had no great impact on the rest of the institutions other than the one that it took over. It operates in 11 Western States. We haven't noticed any real difference in operation.

So the question I would ask you, not disputing what you've said because I agree with you, do you really think changes and modifications in McFadden would diminish markedly the number of independent smaller institutions, both thrifts and commercial banks, where it has not seemed to in New York or in California?

CONCERNED ABOUT TAKEOVER OF SMALL LOCAL BANKS

Mr. **Dennis.** One of the things we're concerned about is the takeover by regional banks of smaller local banks simply as a means to compete with the very, very large bank. We see a situation where many towns and neighborhoods would lose their little local neighborhood small town bank simply because there were others that felt they would ultimately need to compete with the very, very large ones.

In other words, we wouldn't expect, say, Citibank or someone like that to go down to Two Rivers, Tex. or some other little place and buy a local bank. But what may happen is a regional bank of some type may feel it's necessary to get a broader base in order to compete with Citibank.

The **Chairman.** But isn't that happening now even with McFadden? There are all sorts of grandfathered institutions. There have been many interstate mergers of troubled institutions, bank holding companies.

Mr. **Dennis.** Oh, yes. Yes, it is, and we think that if this type of thing continues that ultimately we are going to have a diminution of the viability of smaller banks. Yes, it is going on now and we don't see this as a particularly positive trend. It is happening and what we think is necessary is that, as many witnesses said earlier, that guidelines be established as to what the future of this banking industry is going to be, what are the rules going to be in the next 10 years.

The Chairman. How do you explain, again with Bank America, that more new banks, new independent ones, were created in California last year than at any time in history, even large as Bank America is.

Mr. Dennis. Well, that's a new statistic to me, so I would have to think about it. I honestly would. I can't answer that for you right now.

The Chairman. And we've got a situation where a lot of them in my own State, a lot of the small independents, have been deliberately created for the sole purpose of getting enough deposits hopefully that somebody bigger will buy them out, with no intention whatsoever of providing the traditional personal good service of a small town bank?

So I often wonder in my own State if we have been too lax in the creation of new banks with some of the trouble that they've gotten into, for the sole purpose of surviving long enough to be bought out.

Well, the answers aren't easy. There's no doubt about it. But you suggest that if interstate banking deregulation is to occur, one way to do that would be to allow for regional interstate banking.

What do you think of the experiment in New England, the six States there?

Mr. Dennis. Well, it's still relatively early and our data don't allow us to differentiate the New England area with regard to the small business availability of credit and that sort of thing from the rest of the country. So we are just not sure how things are going at this time.

The Chairman. Do you think those kind of interstate experiments are valuable in answering some of these questions?

Mr. Dennis. Yes; I am personally and we as an organization consider experiments, whether it be in banking or in other types of social and economic type legislation, are generally healthy and useful.

The Chairman. Well, you've been saved by the bell. We have a vote, but we do appreciate very much your willingness to testify. Thank you very much.

The committee is adjourned.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]